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THE

Winter 1990/91

BROOKINGS

REVIEW

A Clean Sweep of the Thrift Industry

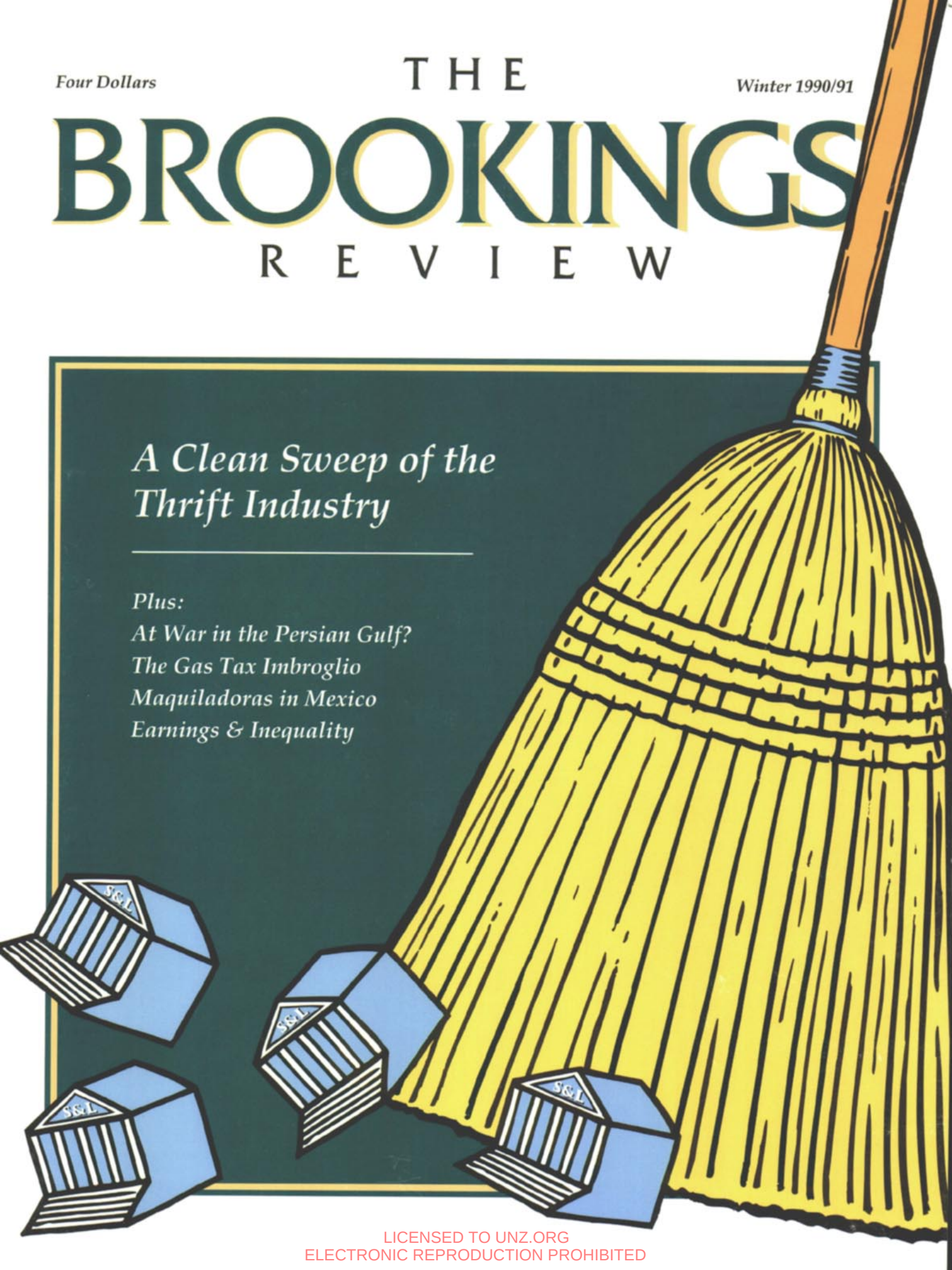
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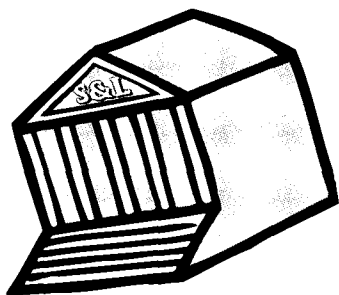
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Child Care: Excessive State Regulation Is Not the Problem

William Gormley's recent article on child care regulation ("Regulating Mr. Rogers' Neighborhood," fall issue) correctly framed some of the tough — if not impossible — choices states and local communities face as they attempt to protect children cared for outside the home. Unfortunately, the root of the problem lies not in an excess of state regulation, as Gormley suggests, but rather in a chronic lack of resources in America's child care system.

Gormley recognizes both the importance of state regulation in ensuring quality and the "huge disparities" in the adequacy of regulation that now exist between and within states. The Children's Defense Fund recently documented these disparities in a comprehensive report entitled *Who Knows How Safe? The Status of State Efforts to Ensure Quality Child Care*. At the same time, Gormley appropriately notes that overzealous or unreasonably burdensome regulations actually can reduce the supply of high-quality, regulated child care programs. Indeed, all forms of regulation, whether for clean air, consumer protection, or adequate minimum wages, impose costs and affect supply. The challenge is to strike an appropriate balance between those costs and the essential benefits of government regulation.

This is precisely where Gormley's argument falters. He fails to offer convincing evidence that current state child care regulations have crossed the line and become unjustifiably stringent or unduly burdensome. Yes, as Gormley notes, local zoning ordinances and overlapping regulatory systems can thwart the development of new child care programs, and we need to work to eliminate these barriers. But he fails to build a case for his suggestion that states weaken their most basic licensing standards — most notably, maximum child-staff ratios — as a way of reducing costs or increasing salaries for child care providers.

Child-staff ratios by definition impose some financial burdens and constraints on child care programs. It obviously is cheaper to assign a staff person to care for eight infants instead of four, and it is precisely this incentive to stretch staff too thinly that makes child-staff ratios so important. Gormley ends up recommending higher child-staff ratios than currently required by states, but where's the evidence to indicate that today's child-staff ratios are excessively tough?

Numerous studies have shown that appropriate child-staff ratios are an essential element of child care quality, particularly for infants. Many states now re-

quire child-staff ratios that already are far higher than levels recommended by child development experts. For example 19 states allow a single caregiver to care for five or more infants, and some states have limits as high as seven, eight, or even twelve infants.

Gormley's suggestion that "a well-trained provider who cares for eight children at home needs regulation less than a poorly trained provider who cares for only one" is sheer nonsense. While training for providers is another essential element of quality, it offers no substitute for adequate staffing to cope with emergencies and give children the attention and stimulation they need.

Only at the close of his article does Gormley offer a glimmer of recognition of the true child care dilemma: America's child care system is so starved for resources that unacceptable trade-offs between quality, affordability, and supply now are unavoidable. The challenge is not to jettison key protections for children, but to make the necessary investments in child care so that our choices are more reasonable. The bottom line of all our concerns must be the protection and quality care of children.

Marian Wright Edelman
President, Children's Defense Fund

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Long-Term Care: Not All Myths Are Created Equal

Joshua M. Wiener and Katherine M. Harris ("Myths and Realities," fall issue) have updated the long-term care financing debate in a provocative fashion by asserting that there are eight notions that policymakers should no longer regard as "truths."

Although dispelling myths is essential to advancing the policy debate and pushing it in the right direction, not all myths are created equal. Nor should they be treated equally by the research and policy world.

Frankly, it is rather discouraging to me, as I'm sure it is to Wiener and Harris, that some of the myths still survive. Since the late 1970s and through the 1980s, national surveys, research demonstration projects, and scholarly evaluations and studies have addressed the question of who the long-term care population is, who provides their care, and what kind of care they use.

In defiance of an extensive body of research, one notion, in particular, continues to have a life of its own. The perception that home care reduces long-term care expenditures by substituting for nursing home care is a major obstacle to progress in the whole arena of long-term care financing. A comprehensive evaluation on the subject by the General Accounting Office drew conclusions in 1982 that many policymakers have yet to acknowledge today. The report pointed out that cost is a moot point — the real issue is that people want home care, they are happier in their homes than in nursing homes, and that, therefore, policymakers should focus on how to deliver and pay for such care (GAO/IPE-83-1).

In a related matter, Wiener and Harris dispel another hardy myth by presenting solid evidence that family and friends continue to provide help to their

disabled relatives when paid home care services become available. This finding should be considered within the context of home care costs. Policymakers cannot expect the presence of family support to discourage participation in public programs unless they are willing to design programs that explicitly limit coverage solely on this basis. Research shows that disabled people will receive the paid services they need and continue to receive help from informal caregivers; the two sources are additive and necessary, not substitutions for one another.

The conclusions drawn by Wiener and Harris in dispelling three other myths are not based on nearly the same foundation of research and understanding as those presented earlier. Their conclusions in these areas, therefore, should be viewed as catalysts for further thinking and research rather than "truths."

It is truly myth shattering to propose that Medicaid "spend down" in nursing homes is a relatively uncommon event. After all, the notion that vast numbers of middle class elderly spend all their assets on nursing home care and then turn to Medicaid has been the very basis for long-term care financing reform. I agree with Wiener and Harris that policymakers must take this new information into account when considering various public roles in paying for long-term care. But this conclusion raises more questions than it answers, especially given the data upon which it is based and the concomitant finding that a very large number of elderly are Medicaid-eligible from their first day in a nursing home. More information is needed before appropriate actions are clear.

I agree with the authors' conclusions about the myth that private insurance is not the only solution for financing long-term care. There is more than enough

financing for both the public and private sectors to handle. But I disagree with any conclusion drawn today about how large the private market might grow based on one computer model making 40-year projections, particularly because industry experience began only five years ago. Since 1987 the number of people who have bought long-term care policies has doubled; the number of people covered under employer-sponsored plans has increased fourfold. Clearly, Wiener and Harris's finding that there will be only a limited future role for private insurance is not grounded on anywhere near the same level of experience, data, analysis, or evaluation available to dispute other myths.

Last, dispelling the final myth — that all developed countries except South Africa provide long-term care on a social insurance basis — is a valuable new contribution to the debate. Although more research is needed, preliminary evidence suggests that a totally public, non-means-tested approach is not a fiscal reality anywhere in the world.

Foreign visitors are often eager to learn how private insurance might fit into their country's long-term care picture. In this regard, the United States may be seen as a leader rather than a country shamed into following the direction of other countries that may not know where they are headed.

Susan Van Gelder
Health Insurance Association
of America

Joshua Wiener and Katherine Harris draw our attention to several myths they see as hindering our progress in dealing with long-term care. Underlying their

own reinterpretation of the conventional wisdom on long-term care issues is a bias favoring government solutions, with little hope for private market responses to the needs of our aging population.

We should not so easily dismiss the possibility of bolstering the commitment of families and other volunteers to increasing unpaid care. Consider, for example, creative ideas like the Service Credit Banking projects that have been developed on a pilot basis around the country. Young and old volunteers have been encouraged to provide significant new informal care to the elderly with the simple commitment to "pay" them with similar services when they themselves may need them.

One myth — that government is not significantly involved in long-term care — is ignored by Wiener and Harris. The reality is that government programs already pay about half the long-term care expenses of our elderly, primarily through Medicaid. Whether this is enough may be debatable, but it is on the order of the percentage of the bill paid by Medicare for the elderly's acute and ambulatory expenses. I believe it is more constructive to view the role of Medicaid in long-term care as an opportunity upon which we can base creative private financing options.

With this idea in mind, a number of states have been developing more affordable and appealing private insurance options that work in partnership with their Medicaid programs. Building on Medicaid, a state-centered approach allows for the development of financing reforms that are consistent with the reality of present economic and political constraints.

The real unspoken reality is that the need for long-term care is part of the normal aging experience for some significant minority of our elderly, and it is at least as important that we encourage adaptation in the private sector

as it is to shore up our already significant public financing and delivering system. Long-term care is a challenge that we must begin to deal with now if we hope to keep it a manageable problem in the future. We cannot afford to accept the premise that public solutions are the only way to go.

Mark R. Meiners
University of Maryland Center
on Aging

"Choice" and the Public Schools — How's That Again?

I write to congratulate John Chubb and Terry Moe ("America's Public Schools: Choice Is a Panacea," summer issue) on a superb piece of irony — one reminiscent of Jonathan Swift's "Modest Proposal." Their approach to the controversial idea of "choice" — to construct such a bizarre argument in its favor as to demolish it completely — is especially refreshing at a time when we are being subjected to so much sober thought on the question of improving America's schools.

Especially clever is the idea of supplanting the form of bureaucracy now in place (which, even with all its disadvantages, remains at least comprehensible to American citizens) with an incomprehensible bureaucratic system of "Choice" and "Information" centers. Their proposal that all parents and students would be required by law to visit the "Choice" center is another nice touch. Their clearly ironic suggestion that institutions of political authority, governed entirely by politics and, in turn, governing other institutions politically, will, stunned by the cogency of this proposal, cease to be what they are and voluntarily cede power — this is

just one of many marvelous bits of tongue in cheek.

Of course, in this as in all human undertakings, there remains room for improvement. For example, one of their obvious satiric tactics against the "choice" movement is to make clear the inequality of opportunity it creates, its favoring of the wealthy and the privileged. Had they suggested a national rather than a state-run version of their "revolution," their satire might have been even more effective. Why not, for example, modestly propose that the REAL solution to all our educational problems would be to gather all of the poor and disenfranchised into certain sections of the country (sections of the upper Midwest come to mind), while the children of the privileged might finally find their way, from around the country, to more desirable locations — say, somewhere near Palo Alto.

That said, "Choice Is a Panacea" remains a fine piece of satire. My congratulations to its authors and to *The Brookings Review*.

James Slevin, Fellow
Virginia Center for the Humanities
Charlottesville, Va.

Back to Geography Class

In your article entitled "Earthquake! Planning for the Big One" (fall issue), there was an error. Based on figure 1 (Earthquake Risks), three states were named as having portions that are "totally immune to earthquake risks." The states named were Florida, Mississippi, and Texas. Figure 1 clearly shows that portions of Alabama, not Mississippi, "are immune to earthquake risks."

Barbara W. Harrell
Alabama Department of Public Health

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Back to Budget Basics

by George L. Perry

It is time to put aside the debate over the budget deficit that has preoccupied Congress and the administration for so long. There is only so much time and energy available to expend on economic and social legislation. The consensus needed to legislate in our political system can take only a limited amount of strain, and fighting over how to reduce deficits has tested that limit. Even though we are not headed for the budget surplus that many economists would like, the deficit is under adequate control for now, and other important economic and social matters demand the attention of legislators.

The idea that deficits are under control deserves a little explaining. After all, this year's deficit will be a record \$300-plus billion. But the current deficit is not the issue. It will be large both because economic activity is weakening, automatically cutting revenues and raising transfer payments, and because this year's deficit reduction agreement contained only small budget savings at the start. Steadily declining deficits in subsequent years lead to a projected surplus by 1995.

Although this longer-run path is what matters, it is fair to ask why anyone should believe it will happen. Past deficit projections under Gramm-Rudman-Hollings have never been met or even approached. But those projections specified only a wish list of deficits, with no spending or tax programs to achieve them. The new agreement specifies realistic and enforceable expenditure ceilings. Within broad expenditure categories, spending more on some program requires either spending less on another or adding new revenue. This leaves room for budget mischief, but not too much.

The official deficit projections still make unduly favorable economic as-



sumptions and include a surplus after 1993 for the thrift bailout. After adjusting for these, the projected 1995 deficit at high employment is 1 percent to 1½ percent of GNP. That may not be optimal fiscal policy. But it is a high-employment deficit only slightly larger than in the 1960s and 1970s, and well below the average of the 1980s.

Reopening the deficit debate would run a serious risk of being counterproductive if Democrats and Republicans started horsetrading over tax changes. You do not have to believe in the supply-side tooth fairy to prefer a tax system with a broader base, lower rates, and no loopholes to its opposite. Yet any attempt by the Democrats to raise more income tax revenues from upper income groups will renew the Republicans' drive to cut the tax rate on cap-

ital gains. There are plenty of arguments to be made on all sides of the capital gains issue. But what cannot be disputed is that a capital gains preference will open a new tax shelter industry that was largely closed by the 1986 tax reform. If tax shelters again become important to private decisions, a lot of investment funds will go not where they are most productive but where they are most sheltered from taxes. Such misdirection of funds would undo many billions of dollars of deficit reduction in its effect on growth and productivity.

Even more important, reopening the budget deficit would push other important issues off the political agenda. We need to find ways to contain the price and total cost of health care to slow consumer price inflation and the growing demands of medical care on the federal budget. At the same time, we should look hard for ways to reduce the risk for the 30-odd million Americans now without medical insurance. The financial crisis of the thrift industry is extending to other financial institutions that made bad real estate loans. The government needs to review its place in insuring and regulating such institutions as it considers overhaul of the banking system. Eastern Europe and the Soviet Union need our help in moving to democratic market economies. At home the problems of crime, drugs, and homelessness and the needs for better education and infrastructure all vie for our lawmakers' attention.

Some of these issues will cost additional money, others may save. But all deserve more attention than they have been getting during the past several years of unending budget crises. Congress and the administration can now afford to put the budget deficit issue aside, and they should. □

George L. Perry is a senior fellow in the Brookings Economic Studies program. He directs the Brookings Panel on Economic Activity with William C. Brainard.

Getting Out of the Thrift Crisis, Now!

Robert E. Litan

It is now nearly two years since President Bush announced a far-reaching plan for cleaning up the thrift industry. At the time, the administration projected total costs of \$100 billion. Since then, the cost estimates have steadily mounted. At last count, official administration estimates put the cost of completing the effort, including the cost of honoring commitments on thrifts closed or sold during 1987 and 1988, at upwards of \$140–180 billion. Congressional watchdogs from the General Accounting Office and the Congressional Budget Office believe the costs could be even higher.

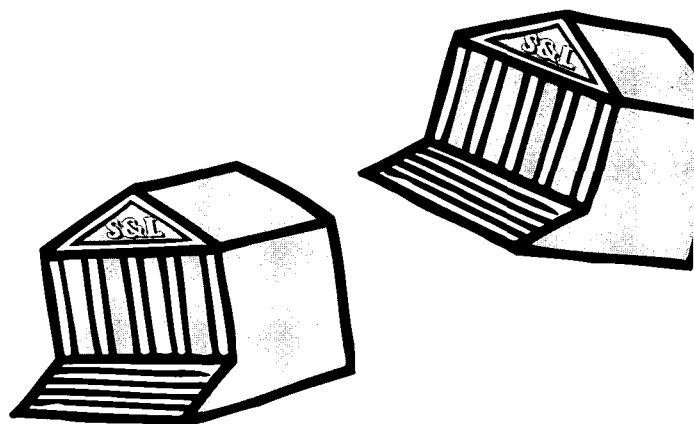
The cleanup also has proved far more difficult than expected. Many more thrifts must be put out of business than were targeted in the administration's 1989 thrift plan. In addition, the agency charged with closing insolvent thrifts and selling off their assets, the Resolution Trust Corporation, has found itself besieged by critics and swamped with a substantially greater volume of assets, many in worse condition, than originally anticipated. As the months drag on and insolvent thrifts and their assets continue to pile up at the RTC's door, Congress and the public are growing weary. The thrift cleanup effort threatens to become a "financial Vietnam," seemingly with no end, let alone victory, in sight.

There is no real way "out." The damage has been done, and the nation must pay, and pay dearly, for it. But there is a way to put the worst of the mess behind us quickly and to move beyond today's destructive wrangling and recriminations to rebuild a healthy depository institutions industry. It is also possible to save money in the bargain. Let me explain.

Progress of the Cleanup

The progress of the cleanup is best measured against its original targets, announced by the Bush administration in February 1989: removal of some 500 insolvent thrifts within three years. The plan also provided for the anticipated failure of 200 additional thrifts through the year

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1999. On these assumptions, roughly 2,300 of the nearly 3,000 thrifts in business in 1989 would still be in business as the nation moves into the 21st century.

Initially the plan assumed that the cost of shutting down the first 500 thrifts would be roughly \$50 billion — about 15 cents per dollar of assets held by the targeted thrifts at the beginning of 1989. It was assumed that these thrifts would not suffer further losses due to poor investments. The plan also allocated \$24 billion for “resolving” the other 200 thrifts — a cost of some 10 cents per dollar of assets. The total estimated present value cost, including \$34 billion obligated for 1988 thrift resolutions, was \$108 billion.

The scope of the thrift disaster has proved far worse. Between August 1989, when Congress enacted a modified version of the administration’s thrift cleanup plan, and the end of September 1990, the RTC had resolved 287 insolvent thrifts that once held almost \$100 billion in assets (measured at inflated book values). As of the end of the third quarter of 1990, the RTC held another 220 thrifts with a total of \$113 billion in (book value) assets in “conservatorship,” pending their dissolution or sale. Table 1 indicates that many more thrifts were doomed at mid-year 1990 than anticipated in early 1989: at a minimum, the clearly insolvent 244 thrifts in Group 4, as well as many, if not most, of the 350 thrifts in Group 3 that, on average, had a small positive capital-to-asset ratio, but were still losing money.

The problem could easily grow worse. While the nearly 700 thrifts in Group 2 appear well capitalized, with an average capital-to-asset ratio above the regulatory minimum of 3 percent, these thrifts are barely profitable. Moreover, the balance sheets of many do not yet fully reflect the fall in real estate values throughout 1990. Accordingly, the CBO has projected that 70 percent

of this group of thrifts could eventually meet their end, requiring government payouts well after the RTC is supposed to close shop. If this projection proves accurate, fewer than 1,500 of the roughly 2,700 thrifts now operating as thrifts will be in business (as thrifts or commercial banks) in the year 2000.

The cleanup is also turning out to be more expensive, on a per resolution basis, than originally expected. The RTC projects that removing the first 287 thrifts from the system will cost \$34 billion, a little more than a third of the \$98 billion in assets these thrifts once held, more than double the loss rate expected.

Like the Federal Deposit Insurance Corporation when it disposes of insolvent banks, the RTC has three ways to resolve insolvencies. The preferred option — which the RTC has exercised for about half the thrifts shut down through mid-1990 — has been to find a buyer to take an institution and then to assist the trans-

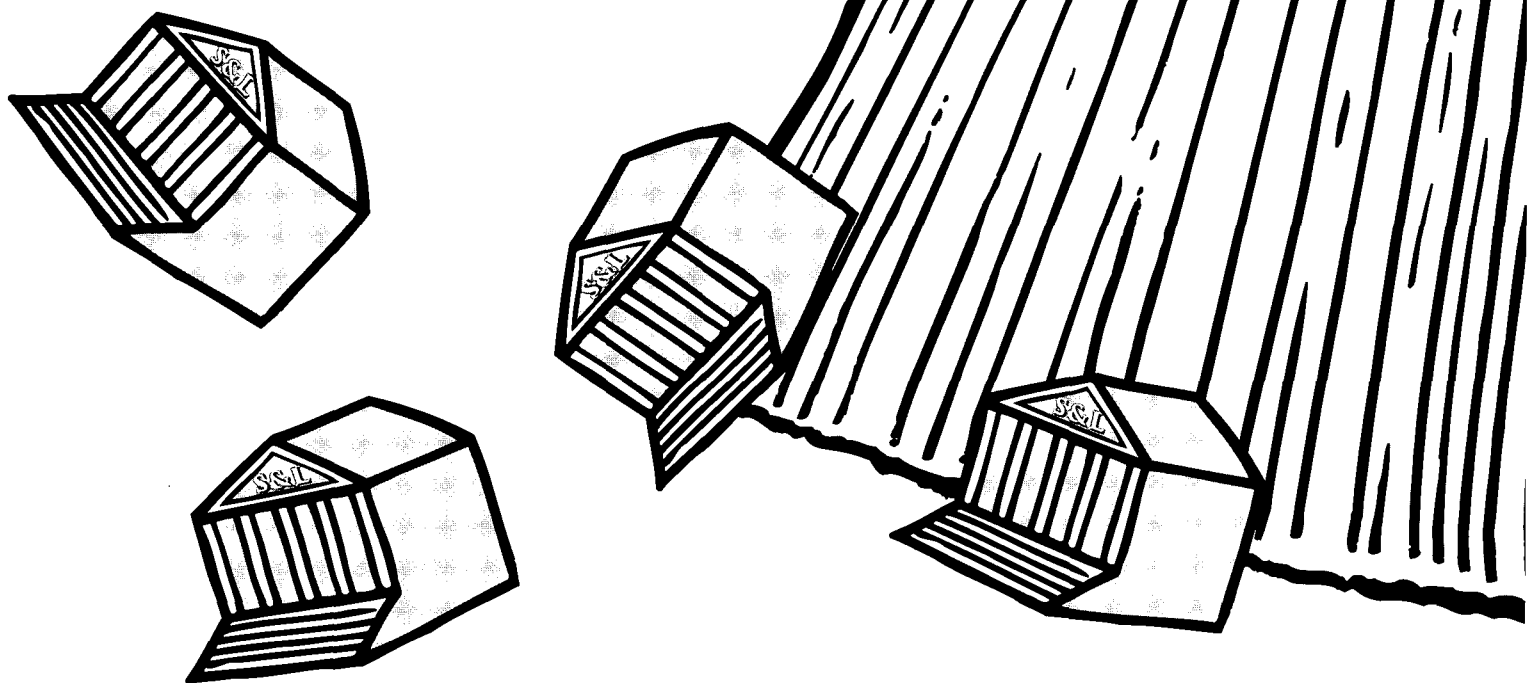


Table 1: Condition of the U.S. Thrift Industry, June 30, 1990

	Group 1	Group 2	Group 3	Group 4	Conservatorship	Total	Total not in Conservatorship
Number of institutions	1,169	674	350	244	247	2,699	2,452
Total assets (billions of dollars)	371	352	165	162	131	1,181	1,050
Annualized profits (billions of dollars)	2.7	0.4	-1.0	-3.0	-9.6	-10.4	-0.8
Annualized return on assets (percent)	0.73	0.11	-0.61	-1.85	-7.33	-0.88	-0.1
Tangible capital- to-asset ratio	6.38	3.82	2.14	-1.39	na	na	3.24

Source: Office of Thrift Supervision and Resolution Trust Corporation. Details may not sum to totals because of rounding; figures exclude 15 new thrifts.

na: Not available.

action by providing cash to make up the difference between the estimated value of the assets and the deposit liabilities. This approach, called a purchase and assumption (P&A), in which the buyer purchases assets and assumes liabilities of the troubled thrift, may take many different forms. The "whole bank" method involves the purchase and assumption of virtually all assets and liabilities. Sometimes a buyer may wish to purchase only a portion of the assets. Buyers can also demand either guarantees of asset values or the option to return some of the assets at a future date.

If a P&A cannot be arranged, either because no buyer is interested or because it would be cheaper simply to liquidate the thrift, the RTC will then attempt to transfer the deposit liabilities by auctioning them off to prospective buyers and dispose of the assets later. In the rare cases when no buyers can be found even for deposits, the RTC liquidates the thrift, pays off the depositors, and takes back all the assets.

The RTC, as does the FDIC, prefers whole bank P&As because they keep most of the assets and liabilities in the private sector. The government, after all, is not ideally suited to run depository institutions or dispose "problem assets," nor should it be. The RTC can hire the work out to private contractors, but the rigidities of federal contracting, coupled with the strict conflict-of-interest

rules imposed by the 1989 thrift legislation, complicate even this second-best option. Thus, it took the RTC nearly a full year to hire its first private contractor to manage a small portion of its problem real estate.

Despite all the advantages of P&As, the RTC has had only limited success with them. Although P&As accounted for 81 percent of the assets of the thrifts resolved through mid-1990, less than half of those assets have been transferred to new owners. Put simply, buyers of dead thrifts don't want most of their assets. By September of 1990 the RTC found itself holding \$42 billion in assets of thrifts that had been closed down and controlling another \$119 billion in assets of thrifts in conservatorship, waiting to be closed.

The RTC may easily end up with more assets, even without closing any more thrifts. Given the highly uncertain value of many of the assets held by insolvent thrifts — uncompleted buildings, undeveloped land, and the like — the RTC has had to give buyers a "put option" that allows them to return the assets, at a fixed price. Before the RTC took over the job of resolving problem thrifts in 1989, the Federal Home Loan Bank Board had given buyers put options that lasted as long as 10 years. To avoid the strong criticism leveled against that policy, the RTC tried initially to limit the put options to 6 months, but has since extended them to 18

months to encourage more buyer interest.

Properly done, P&As also take time to arrange. Prospective buyers want time to examine the financial records and operations of the thrifts on which they are bidding. For that matter, not that many buyers — generally only other healthy banks and thrifts — are interested in dead thrifts. Given the array of thrifts the RTC is trying to sell and the limited money for assisting prospective buyers, it has had little choice but to proceed gradually.

For all these reasons, coupled with expected snags due to startup difficulties, the RTC got off to a slow start. During its first eight months, it was able to resolve only 52 thrift insolvencies. As congressional impatience with the slow pace mounted, the RTC promised in the spring of 1990 to speed up. It fulfilled its promise, putting 155 insolvent thrifts out of business in the second quarter of 1990 alone, by shifting strategy. Rather than waiting for buyers to purchase entire thrifts, it accepted bids for just the deposits of failed thrifts, taking back most or all of the assets.

One effect of the new strategy was to focus attention on the agency's enormous appetite for "working capital," or temporary financing to effect deposit transfers and to carry the assets of dead thrifts until they are sold. Although the issue was given virtually no attention during the debate over the 1989 thrift legislation, the RTC's need for working capital is now a chief focus of congressional and public concern.

Through the third quarter of 1990, the RTC had already run through \$74 billion in cash. Although the RTC will recover some portion of its up-front cash outlays when it sells the assets it has acquired, in the meantime its cash outlays have wreaked havoc on the federal budget. As shown in table 2, RTC expenditures increased the federal budget deficit by \$36 billion in fiscal year 1990. Over fiscal years 1991–93 RTC net spending should push the deficit up by a total of \$143 billion. Not until 1994 will the cash receipts from asset sales exceed expenditures.

How long will the RTC be in business? According to the 1989 thrift plan, the agency was supposed to close the first 500 thrifts within three years, then hand over its job to the FDIC. If the RTC can get the working capital — a mighty "if," as discussed below — it should be handling about 300 thrift insolvencies a year. By September 1990, roughly 800 thrifts were either in conservatorship or highly likely to be resolved (those in Groups 3 and 4). At the 300-a-year pace, the RTC would finish this group of thrifts by mid-1993. If, however, the RTC or the FDIC must resolve an additional 600 or more thrifts in Group 2, the job would take

until mid-1995. And however long it takes to put all insolvent thrifts out of business, the government must still dispose of all assets inherited from dead thrifts, a job likely to extend well beyond 1995.

The RTC's job was made temporarily harder when Congress adjourned in October without authorizing *any* of the \$100 billion in working capital that the agency had requested for fiscal year 1991. Although Congress will probably provide new funds in early 1991, it is likely that the RTC will be put on a short leash, perhaps with spending authority for as little as three to six months at a time.

The seemingly orderly pace of the cleanup, however, is costly. The RTC is liable for all operating losses of insolvent and weak thrifts until they are closed. One source of loss is the high interest rates that problem thrifts must pay to keep their depositors from deserting them. A second source of loss is "gambling" — making risky loans to escape insolvency — by weak thrifts not yet in conservatorship. In addition, to maintain liquidity, these thrifts tend to sell their better quality assets before the RTC seizes control, a practice that means even greater losses per dollar of assets at resolution.

A third cost of the gradual cleanup is the loss in the weak thrifts' "franchise value" to potential acquirers. Through mid-1990, for example, the RTC estimated that it saved about \$1 billion by completing P&As or auctioning off deposits instead of simply paying off depositors. This saving, which represented 2.7 percent of the "core deposits" (those with balances below \$80,000) in these thrifts, can be viewed as the premium that buyers, in the aggregate, were willing to pay for the thrifts as ongoing institutions. This franchise value in weak and insolvent thrifts, however, falls over time as depositors, knowing that their institutions eventually will be closed, gradually move their business elsewhere.

Taking account of additional asset deterioration, administrative costs for maintenance of conservatorships, and working capital financing, the CBO estimated last

Table 2
Effect of RTC on U.S. Budget Deficit, Fiscal Years 1990–95
Billions of dollars

	1990	1991	1992	1993	1994	1995
Deficit	195	232	239	194	146	138
Net RTC effect	36	70	60	13	-30	-18
Deficit without RTC effect	159	162	179	181	176	156

Source: Congressional Budget Office, *The Economic and Budget Outlook: An Update* (July 1990), pp.32, 50.

July that the delays built into the RTC's current resolution process will increase the final cost of the thrift cleanup for 800 thrifts by up to \$50 billion. The question that immediately arises is whether anything can be done to speed the pace, and thus lower the cost, of the cleanup.

Option One: Sweeten the P&As

One obvious way for the RTC to speed up its pace is to sweeten the terms of its P&A offers. If relatively few buyers are willing to take whole insolvent thrifts off the RTC's hands with put options of only 18 months, then perhaps the RTC should either provide more of a cash bonus up front or extend the put options.

By law, however, the RTC can complete a P&A only when it costs less than liquidating the thrift (the FDIC

criticism — buyers of whole thrifts now would obviously demand healthy cash premiums to cushion them against the uncertainties of taking over these institutions without the chance to return problem assets to the RTC in the future. And the problem with large cash premiums is that buyers who guess right about asset values would obviously reap tremendous gains at taxpayer expense.

As is evident in the ongoing congressional investigations of the 1988 deals, legislators from both political parties are reflecting broad public discomfort, if not anger, that certain buyers stand to reap substantial tax benefits and profits from the thrift disaster. As in 1988, the process of selling off failed thrifts today would, by its very nature, be bound to create the impression that the sales are not really "auctions," but exclusive negotiations with buyers who have "inside tracks" to the agency.

Even bidding on a failed thrift is an expensive proposition. Prospective buyers must conduct "due diligence" audits, reviewing where possible the condition of the assets and liabilities of the institution. With so many thrifts on the auction block today, the relatively limited number of prospective buyers inevitably would tend to concentrate their energies on a limited number of institutions. The Resolution Trust Corporation would thus find itself in much the same position as the Bank Board in 1988, with few interested parties for many, if not most, of the thrifts on its plate. The impression given to the public would

thus be of deals being cut in private.

Hardly anyone in Congress defends the 1988 transactions. Clearly, asking the RTC to return in spirit to the 1988 deal-making philosophy — whether with cash up front or with longer guarantees than the 18-month "put period" the RTC now grants buyers — could be close to political suicide.

Option Two: Clean Sweep

Given the political impossibilities and administrative costs of resuscitating the "sweetened" P&A approach, the only other way to speed the cleanup is for the RTC to accelerate what it has already been doing — that is, auctioning off deposits and taking back assets.

To be more specific, the RTC should undertake an immediate "clean sweep" of all currently insolvent thrifts — some 500 institutions as of September 1990 — as well as all thrifts too weakly capitalized to survive. In all, a minimum of 850 institutions with about \$450 billion in reported assets would be involved. Ultimately, up to 674 more thrifts in Group 2 could require similar treatment.



operates under the same legal requirement). Figuring out whether complicated P&As actually cost less is no easy job. As it is, with the benefit of hindsight, it is difficult to say confidently that many of the pre-1989 P&As were really cheaper than liquidation. For the RTC to provide greater incentives to encourage thrift buyers to take more assets could mean running afoul of the law.

Of course, the RTC could seek to get around legal hurdles to sweetening its P&A deals by increasing its estimates of the cost of liquidating thrifts to take into account additional costs of disposing of their assets. Such a course, however, would be politically disastrous in light of the recent scathing criticism of the P&As arranged by the RTC's predecessor, the Federal Home Loan Bank Board, in 1988 (see box for details).

Those who would sweeten the current P&A offers would have to find a way to attract buyers in the face of tremendous uncertainties about the value of thrift assets — a problem that, given the recent economic downturn, may be even worse today than it was in 1988. Without the blank check guarantees of the kind handed out by the Bank Board in 1988 — now the target of such hostile

The 1988 Thrift "Deals"

Back in 1988 the Federal Home Loan Bank Board found itself between the proverbial "rock and a hard place." It had virtually no cash reserves in its insurance fund, the Federal Savings and Loan Insurance Corporation, with which to close or assist the sale of about 700 insolvent thrifts then open and holding more than \$300 billion in assets. But by permitting them to stay in business, the Board would be allowing them to gamble for resurrection with federally insured funds. To add some urgency to the situation, the Board faced the prospect that the end of 1988 would see the expiration of certain tax benefits — primarily those permitting buyers to deduct the losses of insolvent thrifts against their other income — enacted by Congress to encourage buyers to take insolvent thrifts off the government's hands.

The Board decided it was a greater risk to allow the insolvent thrifts to stay open than to sell them without the cash it needed to assist buyers. In effect, it decided to "print government obligations" without explicit congressional authorization. Had the FSLIC had the cash for these transactions, it most likely would have offset any negative net worth in these institutions with cash, as the FDIC typically does when assisting the sale of insolvent banks. For example, in the case of a hypothetical insolvent thrift with assets of \$60 million and with negative net worth, measured at market value, of \$40 million, the FSLIC would have provided the full \$40 million in cash to a buyer, less any "franchise value" of that thrift to the highest bidder. In return, the buyer would have infused sufficient capital to bring the now revived thrift up to prevailing capital standards — in 1988 about 3 percent of assets, or, in this example, \$3 million (3 percent times \$100 million in

assets counting the FSLIC cash assistance).

With the FSLIC itself effectively insolvent in 1988, the Board instead promised *future* assistance of value equivalent to the cash it would otherwise have provided. In principle, the Board could have provided all future aid in the form of a promissory note. But the insolvent thrifts were generally in such bad shape that no one, neither the FSLIC nor prospective buyers, had any confidence in estimates of their negative net worth positions. Given this "valuation problem," buyers insisted that the bulk of the aid be provided in the form of guarantees: against the erosion of interest earnings on "problem assets" and against losses in the event those assets were sold for less than originally valued. Typically, the Board provided these guarantees for as long as 10 years. In effect, the Board "solved" the valuation problem by deferring it: not until 10 years down the road would the government actually know how insolvent the thrifts were and how much it was going to cost to restore them to health.

Several other features of these 1988 deals are worth noting. In contrast to general FDIC practice in resolving failed banks, the Board granted buyers of insolvent thrifts temporary "forbearance" from meeting capital standards. In addition, by completing the transactions before the year-end 1988 deadline, the Board was able to confer substantial tax benefits on acquirers. Although the Board typically shared in these benefits (by deducting them from the total assistance otherwise provided), the fact that buyers could take advantage of them meant that the Treasury was helping to finance their purchase of the very institutions the Board was trying to sell.

In all, the Board completed sales

of 179 thrifts in 1988 at an estimated present discounted value cost of approximately \$27 billion. In addition, the Board estimated that the transactions cost the government \$5.5 billion in tax revenues, on the same present discounted value basis.

Critics charge that the 1988 transactions are turning out to be far more expensive than expected. Both the FDIC and the GAO, for example, have added at least \$10 billion to the originally projected cost estimates. Armed with this knowledge, critics contend that the FSLIC should never have completed the deals. It would have been cheaper, they say, to liquidate the thrifts.

Such criticism is beside the point because the FSLIC did not have the cash to carry out such liquidations in any case. A more defensible line of attack regarding the costs is that the terms of the deals arguably were too generous and failed to provide sufficient incentives to acquirers to minimize the government's expense. Was it really necessary for the government to have provided the yield maintenance and capital loss guarantees as long as 10 years? Were it here today, the Board might respond that it included generous assistance because it had no other way to interest buyers in taking the thrifts off its hands. But to the extent the Board's back was to the wall, that was a predicament of its own choosing since many of the 1988 transactions were negotiated *after* the November 1988 elections when the Board had less than two months to complete the transactions before the tax benefits were scheduled to expire. Cynics, of course, contend that the Board picked up its pace of assisted sales in November because the Reagan administration did not want to call attention to the severity of the thrift problem before the presidential election.

The obstacle to a "clean sweep," of course, is a lack of cash for working capital. The problem extends far beyond the dispute between the administration and Congress that has thus far held up approval of the RTC's \$100 billion request for fiscal year 1991. Even \$100 billion will not begin to be enough to complete the job. The RTC needs \$375 billion to honor all the deposits of the minimum 850 thrifts requiring resolution. If it later becomes obvious that thrifts now in Group 2 or even Group 1 require resolution, the total insured deposits at risk could exceed \$500 billion.

Of course the clean sweep would not actually require deposit payoffs. Instead, the RTC would effect the closures by immediately seizing control of all the candidate thrifts and then quickly — within three months — auctioning off their deposits. To enable buyers to honor the deposit liabilities, the RTC would transfer to them all liquid assets currently held by these thrifts, as well as Treasury bonds with maturities spread over 7–10 years, the time it should take for the RTC to dispose of the rest of the assets it would inherit from the failed institutions.

To suggest that Congress appropriate even as "little" as \$375 billion at once is, at first blush, a bit shocking. After all, Congress and the president have just finished months of tortuous political negotiation to reach a bud-

get compromise that is advertised to save \$490 billion over five years. The clean sweep would appear to wipe out most of that saving in one fell swoop!

Appearances are deceiving, however, and once the option is given serious thought, the objections begin to melt away. To begin with, the initial spending will not be the final cost of the cleanup because the RTC will eventually realize gains from the sale of assets. The net cost, after all the assets are sold, of closing all thrifts remaining to be resolved will be more like \$100 billion.

More important, as I have shown, it will be *cheaper* to close the candidate thrifts immediately than to continue at the RTC's present pace. As noted earlier, the delay built into the current strategy entails three costs that a clean sweep could avoid: the costs of servicing high-interest deposits in insolvent thrifts, costs due to further gambling by weak thrifts, and losses to the RTC from erosions in franchise value. Eliminating those costs is likely to save between \$12 billion and \$24 billion. (The difference between this estimate and the CBO estimate of \$50 billion is attributed to somewhat different assumptions concerning the notion of delay — differences in the treatment of working capital and asset maintenance administrative costs.)

First, by shutting down the minimum 850 thrifts immediately, rather than over three years, the RTC could save \$6.3 billion on interest and operating costs (see box for detailed calculation).

The second form of savings — that gained by preventing the gambling for resurrection that so escalated the cost of the thrift cleanup during the middle and late 1980s — is more difficult to estimate. To be conservative, I assume no such savings can be realized by quickly resolving thrifts already in conservatorship or insolvent but not yet placed in conservatorship (the 244 thrifts in Group 4). Presumably, thrift examiners are closely watching the managers of these institutions — at a minimum, stopping the growth of the thrifts or forcing them to shrink. The thrifts in Groups 2 and 3, however, are not as tightly supervised: they are fully capable of taking risks to avoid the clutches of the RTC. As many as 500 of these undercapitalized thrifts (collectively holding at least \$200 billion in assets) are unlikely to survive in any event and thus are highly likely to take risks as long as they are permitted to stay in business. Based on historical rates of gambling by thrifts that have already been resolved, the 500 weak thrifts

Interest Savings

Interest savings represent the difference between the cost of paying interest on thrift deposits and what the government would have to pay on Treasury bonds issued to the buyers of the deposits (to ensure that they could be redeemed).

If the targeted 850 thrifts had been closed at year-end 1988, the government could have saved some \$2.3 billion for 1989. This calculation is based on the difference between these thrifts' adjusted interest expense, taken as a percentage of average assets, and the average yield of three- to five-year Treasury securities. The average interest expense of the 850 thrifts for 1989 was 7.82 percent. To this I add, based on previous operating cost analyses by the Federal Reserve, 1.1 percentage points to account for the cost of operating and maintaining deposits during 1989. Thus, the adjusted interest expenses (interest expenses plus operating expenses) for the 850 thrifts in 1989 is 8.92 percent, or 0.4 percentage point higher than the average yield on three- to five-year Treasuries during 1989. Multiplied against the \$450 billion in average assets held by these thrifts in mid-1990, the 0.4 percentage point saving yields \$1.8 billion — the amount that could have been saved had the 850 thrifts been resolved based on 1989 deposit costs.

According to preliminary first quarter 1990 data for the same thrifts, however, the cost saving would have been \$1 billion for the quarter — or \$4 billion for the year. Much of the increase in cost savings is attributed to the high interest rates offered by thrifts that either are already in conservatorship or are insolvent. Based on the more recent data, the total operating cost savings to the government from immediate closure would be \$6.3 billion.

now in a position to gamble should continue to lose from 2.5 percent to 6 percent of their assets per year until they are shut down. On a total asset base of \$200 billion, the deterioration due to gambling should cost the RTC an additional \$8.4–\$20.1 billion.

Finally, preventing further erosion in franchise value could net savings of at least \$1 billion. As it is, the franchise value that the RTC has realized from P&As and sales of thrift deposits has been relatively small: only 0.7 percent of core deposits on deposit transfers (3.1 percent of core deposits on P&As). But even a little saving helps. My \$1 billion estimated saving results from saving half the premium on core deposits (0.35 percent times the \$375 billion in deposits held by thrifts I believe are certain to be closed).

Quickly putting all insolvent and weak thrifts out of business would promote a more rapid, and much-needed, consolidation of the nation's banking system. As it is now, healthy depositories must compete every day for funds and for borrowers with thrifts that are doomed, a competition that puts pressure on profit margins of the healthy institutions. Ordinarily, competition itself is healthy and in the interest of consumers. But competition by insolvent and weak thrifts is destructive, since these institutions can remain in business only by paying interest rates to depositors that cannot be covered with the earnings on prudently underwritten loans. Keeping inefficient depository institutions in business surely exacts a toll on the nation's economy and represents an additional cost of delay — one I do not include in my estimate of cost savings calculations. But the sooner such competition is driven from the market, the better off the remaining participants — and the nation's financial system — will be.

The savings gained by a clean sweep will be offset somewhat by added costs. The Fifth Amendment to the U.S. Constitution requires that shareholders of solvent, but weak thrifts be compensated for the value of their shares. At most, table 1 indicates that this total could reach \$3.4 billion, or the book value tangible capital held by Group 3 thrifts (the 2.14 percent capital ratio multiplied by \$165 billion in assets). The actual compensation would probably be much lower once thrift examiners marked down the asset portfolios of these institutions to reflect their true market values.

Another source of potential additional costs arises from the fact that the clean sweep option would push all the assets of the weak and insolvent thrifts into the RTC's hands all at once rather than gradually. Arguably that would place costlier administrative burdens on an

Table 3
Assets Managed by the RTC, August 31, 1990
Billions of dollars

	Receiverships	Conservatorships	Total
Cash and investment securities	7.4*	17.7	25.1
Mortgage-backed securities	na	13.9	13.9
Performing loans	16.5	57.1	73.6
Delinquent loans	7.1	10.1	17.2
Real estate owned	6.2	11.2	17.4
Other assets	5.3	8.7	14.0
Gross assets	42.4	118.7	161.1

Source: Resolution Trust Corporation. Totals may not add because of rounding.

na: Not available

* Includes an unknown amount of junk bonds.

agency already deluged with properties. With far more assets to manage, the RTC may neglect many more, allowing them to deteriorate in value faster than they would if thrifts managed them privately.

This concern, though valid, must be placed in perspective. First, as table 3 shows, almost \$113 billion of the \$161 billion in assets managed by the RTC as of the end of August 1990, or 70 percent, consisted of liquid securities or performing loans that should be readily marketable. Roughly similar proportions of the assets the RTC should be acquiring in the future should be of the same type.

Second, immediate closure of all eligible thrifts would give the RTC much greater freedom to repackage assets, currently held by numerous thrifts, into pools of greater interest to buyers. In particular, the RTC could find it easier to sell packages of real estate and related property held by several thrifts in the same metropolitan area, or even in the same state, on a "wholesale" basis to institutional investors than to market it "retail," as it could effectively be forced to do as long as it is closing thrifts gradually.

Third, any added costs of managing such a large volume of assets could be minimized by speeding up the RTC's asset sales program, increasingly a target of criticism for being too slow. In late October the RTC announced a plan for packaging almost \$70 billion of its financial assets to back a securities issue to speed up disposition of these assets. Similar strategies can and should be used in the future. In addition, the recent runup in oil prices, which benefits the Southwestern states where the bulk of the RTC's property is or even-

tually will be located, should make it easier to speed asset sales.

Fourth, it cannot be assumed that privately operated thrifts will dispose of their assets more efficiently than would the RTC or its contractors. Although these thrifts clearly have been shedding assets, the overwhelming proportion of those sold have been, not surprisingly, readily marketable securities. Thus far, at least, troubled thrifts have shown little inclination to sell their less-marketable loans and real estate. One reason is that it is hard to do. More important is that selling problem assets would probably result in a loss and thus a reduction of capital — this at a time when such thrifts are trying any way they can to increase capital. Under such circumstances, it is far from clear that private thrifts could outperform the RTC.

In short, if the assets are properly managed, additional net costs of a clean sweep should come nowhere

porarily. But the underlying economics of the Treasury financing clearly suggests that any such effect would be minimal at best.

The principal reason, of course, is that the government automatically finds buyers of the Treasury bonds used to finance the thrift closures when it pairs the bonds with the deposits of failed thrifts. Put differently, the act of transferring deposit accounts from failed institutions to healthy banks and thrifts that buy the accounts should have no effect on national saving and investment, and therefore no effect on market interest rates.

Still, it is possible that some banks and thrifts that buy the accounts will want to turn around quickly and sell the Treasury obligations that are paired with the deposits, replacing them with higher-yielding loans. They can do so, however, only if they have the additional capital now required to back those loans (the government's

new "risk-based" capital standards require banks and thrifts to have much more capital to support loans than to support risk-free Treasury bonds). Moreover, to the extent that banks and thrifts engage in this behavior, they would be increasing the supply of available funds for bank loans, thereby placing offsetting downward pressure on bank lending rates.

If policymakers nevertheless were concerned about the impact of a clean sweep on interest rates, they could finance the operation with a special issue of "restricted" Treasury bonds, or instruments that the buyers of thrift deposits could not sell to third parties (except perhaps to other buyers of thrift deposits) before maturity. To offset the severity of this restriction, the Federal Reserve could

be required to accept the "restricted Treasury" instruments as collateral for discount window loans.

Given the huge dimension of the thrift disaster, there is no way for the federal government to get completely out of the cleanup business immediately. Even if it closes all insolvent and weak thrifts, the RTC almost certainly will still be disposing of assets formerly held by busted thrifts for years.

close to offsetting the potential operating cost, gambling, and franchise value savings. To the extent that the RTC has too few employees to manage all the assets it would inherit under a clean sweep, it could hire them. After all, the potential savings I am talking about — at least \$12 billion — are on the order of what America's "Desert Shield" armed defense of Saudi Arabia is costing. Surely a nation that can mount that kind of military operation in several months can hire the necessary people — many of whom are currently unemployed real estate professionals — to expedite the RTC's asset sales program.

A different concern about the effects of a clean sweep is a fear that a large up-front expenditure of at least \$375 billion all at once would increase interest rates. To be sure, a Treasury borrowing of that magnitude could have an adverse psychological effect on bond investors that would entail higher interest rates, perhaps tem-

Conclusion

Given the huge dimension of the thrift disaster, there is no way for the federal government to get completely out of the cleanup business immediately. Even if it closes all insolvent and weak thrifts, the RTC almost certainly will still be disposing of assets formerly held by busted thrifts for years.

Nevertheless, I believe it would be a mistake to prolong and increase the agony by proceeding at an orderly pace to resolve failed thrifts. Such a course is needlessly expensive. The government should at least speed up what it both knows how to do and will eventually complete in any event: the forced exit of hundreds of dead, but increasingly costly, depository institutions. □

One of the loudest salvos in the ongoing battle over “choice” in public schools came this year from theoreticians John E. Chubb and Terry M. Moe in *The Brookings Review* (“America’s Public Schools: Choice Is a Panacea,” summer issue). Chubb and Moe propose to transform our public schools from democratically regulated to market-driven institutions. They argue that the past decade has seen the most ambitious period of school reform in the nation’s history, but that gains in test scores or graduation rates are nil. Their explanation: government, with its politics and bureaucracy, so hampers schools’ ability to focus on academic achievement that improvement efforts are doomed.

Using data from the early eighties, Chubb and Moe contend that freeing schools from democratic control boosts performance a full grade level. Thus, they would give students scholarships for any public, private, or newly formed school; prohibit states or school districts from establishing organizational or effective curricular standards or assessing school performance; and allow schools to restrict student entry. They assert that parent choice alone will assure quality.

What’s wrong with this proposal to combine vouchers with radical deregulation? Everything.

In the first place, Chubb and Moe’s basic charge that current reform efforts have not succeeded is dead wrong and, consequently, the need for risky and

radical change unjustified. While their data say something useful about the dangers of rigid bureaucracy and the overpoliticization of education, their findings cannot be used to judge the reform effort, since the students in their study were tested before reforms began. Evidence gathered more recently points to substantial gains.

For example, in 1983 California began refocusing on academic excellence, reducing bureaucracy, enhancing professional autonomy, and moving away from a rule-based to a performance-driven system. We raised standards; strengthened curriculum and assessment; invested in teacher and principal training; established accountability, including performance targets and incentives for good results and penalties for bad; provided funds for team building at the school; pushed for better textbooks; and forged alliances with parents, higher education, and the business community.

The result of this comprehensive approach has been real progress. In 1989, in reading and math, California high school seniors scored *one year* ahead of seniors in 1983, the exact improvement that Chubb and Moe say their proposal would achieve and just what they argue could not be accomplished within

the existing system.

Since 1986, California eighth grade scores have risen 25 percent, the pool of dropouts has decreased 18 percent, and the number of high school graduates meeting the University of California entrance requirements has risen 20 percent. Since 1983, the number of seniors scoring above 450 in the verbal section of the Scholastic Aptitude Test has grown 19 percent, the number scoring above 500 has increased 28 percent, and the rate of seniors passing Advanced Placement tests has jumped 114 percent — to more than 50,000 students a year.

California educators achieved these results even though the number of students in poverty doubled, the number of those who do not speak English doubled to one out of five, and California’s student population grew explosively.

Impressive gains were also made nationally during the 1980s. The dropout pool shrunk by a third; the number of graduates attending college grew 18 percent; and on the National Assessment of Educational Progress, the number of 17-year-olds able to solve moderately complex problems increased 22 percent in mathematics, and 18 percent in science. Reading and writing scores, however, grew less.

Bill Honig

Why Privatizing Public Education Is a Bad Idea

Bill Honig is the California Superintendent of Public Instruction.

Further evidence of improvement in the performance of college-bound American youngsters is that Advanced Placement courses taken have nearly doubled since 1982. The number of students taking the more demanding curriculum, suggested by *A Nation at Risk*, of four years of English; three years of social studies, science, and math; and two years of foreign languages more than doubled between 1982 and 1987, from 13 percent to 29 percent of high school graduates. In science, the number of graduates taking chemistry grew 45 percent to nearly one of every two students, and the number taking physics expanded 44 percent to one of every five students.

Certainly, these gains are not sufficient to prepare American youngsters for the changing job market, to reach their potential, to participate in our democracy, or to keep up with international competition. We still have a long way to go. But that is not the issue. Educators are being challenged on whether we have a strategy that can produce results. We do, and this nation should be discussing how best to build on this record and accelerate the pace of reform — not how to dismantle public education.

It is no exaggeration to say that Chubb and Moe's ideas for change would jeopardize our youngsters and this democracy. Any one of the following objections should be enough to sink their plan.

First, the proposal risks creating elite academies for the few and second-rate schools for the many. It allows schools to exclude students who do not meet their standards — almost guaranteeing exacerbation of existing income and racial stratification. We had such a two-tiered system in the 19th century before mass public education helped make this country prosperous and free. We should not go back 100 years in search of the future.

Second, cult schools will result. Nearly 90 percent of American youngsters attend public schools, which are the major institutions involved in transmitting our democratic values. By prohibiting com-

mon standards, Chubb and Moe enshrine the rights of parents over the needs of children and society and encourage tribalism. Is it good public policy to use public funds to support schools that teach astrology or creationism instead of science, inculcate antiminority or antiwhite attitudes, or prevent students from reading *The Diary of Anne Frank* or *The Adventures of Huckleberry Finn*? Absent democratic controls, such schools will multiply.

Third, their plan violates the constitutional prohibition against aiding religious schools.

Fourth, the lack of accountability and the naivete of relying on the market to protect children is alarming. In the 19th century the slogan was "let the buyer beware," and meat packers sold tainted meat to consumers. In the 20th century deregulation produced the savings and loan debacle. Nobody seriously proposes rescinding environmental safeguards — why should our children not be similarly protected? Look at private trade schools. Regulation is weak, and scholarships are available. The results: widespread fraud and misrepresentation. Similar problems occurred when New York decentralized its school system. Corruption and patronage surfaced in its local boards of education. All across the nation there are calls for *more* accountability from our schools, not less.

Fifth, the plan would be tremendously chaotic. Vast numbers of new schools would have to be created for this plan to succeed; yet most new enterprises fail. Many youngsters will suffer during the transition period, and with no accountability we will not even know if the experiment was successful.

Sixth, taxpayers will have to pay more. Chubb and Moe maintain that competition will produce savings, but they offer no proof. A potent counter-example: colleges compete, yet costs are skyrocketing. Furthermore, if this plan is adopted nationwide, a substantial portion of the cost of private school students — about \$17 billion a year — currently

paid for by their parents will be picked up by taxpayers (unless public school expenditures are reduced 10 percent, which would make the plan doubly disastrous). In addition, the proposal includes expensive transportation components and the creation of a new level of bureaucracy — Choice Offices. These offices will include Parent Information Centers, where liaisons will meet with parents and students to advise them on what schools to choose. But how many employees will be necessary for this process if parents are to receive the information they need in a timely manner?

If this country is willing to spend billions to improve education, there are much better investments with proven returns than Chubb and Moe's fanciful idea. One is providing funds to bring teachers up to speed in math, science, and history. Investing in team-building efforts, technology, improving assessment, Headstart programs, or prenatal care also offers proven returns for the dollar spent.

Chubb and Moe misread the evidence on choice and claim it is the only answer. We *should* give public school parents more choice, either through magnet schools or through open-enrollment plans. Choice builds commitment of parents and students and keeps the system honest. But limits are necessary to prevent skimming of the academic or athletically talented or furthering racial segregation. More important, where choice has been successful, such as in East Harlem, it has been one component of a broader investment in quality.

This country has an incredible opportunity to build a world-class school system. Public schools have turned the corner, educators have developed an effective game plan for the nineties, and promising ideas to encourage further flexibility within a context of vision and accountability are being implemented. If our leaders support that plan instead of chasing will-o'-the-wisp panaceas, come the year 2000, America's children will enjoy the schools they deserve. □

Revolution, Reform, or Regression?

Arab Political Options in the 1990 Gulf Crisis

Yahya Sadowski

An old Arab proverb about the romance of war goes: distant drums, sweet music. Most Washington pundits believe that the Bush administration will bring the Kuwait crisis to a close before the spring of 1991. Either Saddam Hussein's troops will bow to international pressure and walk out of Kuwait, or they will fold before an American military assault and be carried out on stretchers. After this victory America will sit back and enjoy "the new global order." But whatever transpires on Kuwaiti sands over the next few months, America will soon have to confront two painful facts. First, the Iraqi invasion of Kuwait is only one symptom of a much wider crisis in the Arab world. Second, this wider crisis is going to persist and fuel renewed instability in the region regardless of whether America claims a victory in Kuwait.

To many Americans, the Middle East in the 1980s appeared to be an unstable and violent region. The U.S. press was filled with unsettling reports about civil wars in Lebanon and the Sudan and regional wars pitting Israel against Syria and Iraq against Iran. But the truth is, the 1980s was a period of relative stability in the region.

During the 1960s the Middle East was markedly less stable — as it may be again soon. Not only were the

troubles in Lebanon, the Sudan, Israel, and Iran already evident, but they were compounded by a series of conflicts that have since disappeared. The oil-rich, underpopulated, and conservative monarchies of the Gulf were threatened by republican or Marxist insurgents in the Yemen, tribal rebellions in Oman, and underground Arab nationalist parties in Kuwait and Bahrain. The poor, overpopulated, Arab nationalist regimes in countries like Syria and Iraq were wracked by a seemingly endless series of military coups d'état. A regional power struggle, which Malcolm Kerr dubbed "the Arab cold war," aggravated these domestic disputes. The struggle pitted a coalition of Arab nationalist governments led by Egypt against a rival coalition of pro-Western regimes led by Saudi Arabia.

In November 1967 King Feisal of Saudi Arabia and President Nasser of Egypt, both shocked by Israel's victory in the June war, met in Khartoum to call a truce and lay the foundations of a new Arab order. The Saudis and the other Gulf emirates began to offer billions of dollars of foreign aid to the poorer Arab nationalist regimes. In exchange, the nationalist regimes stopped supporting the insurgencies in the Arabian Peninsula and began to collaborate with the Gulf monarchies in dealing with non-Arab security threats like Iran and Israel. Military coups became less frequent because the poorer Arab states were able to buy a measure of popularity among their citizens by offering consumer subsidies, public employment programs, and lucrative state contracts.

That arrangement of buyoffs between and within

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Arab states, sometimes called the Arab state system, was criticized by both Leftists and Islamists, who claimed that it insulated the ruling elites from popular pressures, stifled social change, and fostered corruption. Their criticisms struck a chord, but most Arabs clung to the system because it provided peace, relative political stability, and a rising standard of living.

During the 1980s, however, the system became harder to sustain. The Middle East had an exceptionally fast growing population. Egypt's population, which had been 30 million in 1966, reached 50 million by 1988 and was projected to exceed 67 million by the year 2000. Jordan had the second-fastest growing population in the world (ranking just behind Kenya). The annual growth of population was higher than 3 percent in the Yemens, Sudan, Syria, Iraq, Saudi Arabia, and Kuwait.

Under the best of circumstances such growth would have taxed the local economies, but standards of living were rising too. People who had been content to eat pasta developed a taste for meat. Countries like Egypt and Iraq, which had been food self-sufficient in 1970, today import 80 percent of their basic foodstuffs. This growth of consumer demand might have been met by investing in local industrial and agricultural projects. But a large share of the petrodollar wealth was squan-

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dered by corrupt elites or spent cultivating political loyalty. The few productive ventures that did receive investment were hamstrung by economic policies (such as price controls and overvalued currencies) that inhibited the growth of internationally competitive enterprises. The only sectors of the economy that typically grew faster than population were commerce and government bureaucracy.

In 1982 and again in 1985, oil prices slipped badly. The total value of Arab oil exports, which had been \$212 billion in 1982, fell to \$95 billion by 1987. Petrodollar aid transferred among Arab states dropped correspondingly. At first the oil-poor, heavily populated states tried to compensate by borrowing abroad. Jordan built up \$8 billion in foreign debt; Morocco, \$20 billion; Algeria, \$25 billion; Egypt, \$50 billion; and Iraq, \$80 billion. But within a few years most Arab states had reached the limits of their credit with foreign lenders.

By the late 1980s, it was no longer possible to sustain the expenses involved in propping up the Arab state system. Just servicing existing debts crippled the economies of the poorer states, draining their hard currency revenues. Even the richest Gulf states began to run budget deficits and dip into their cash reserves. Across the Arab world, right-wing monarchies and left-wing military dictatorships faced a crisis of rule. Whatever popularity these regimes had acquired in the struggle against colonial occupation had long since evaporated. The lavish state patronage that had allowed them to maintain their authority was sapped by a growing economic crisis. Increasingly, the mass of Arabs saw their rulers as ideologically bankrupt, politically corrupt, and socially alien.

The Arab state system was eroded and fragile. From 1987 onward, each of the Arab countries began to react — in different ways — to that new reality. Three different styles of reaction prevailed, according to the needs and assets of each country. Kuwait, Jordan, and Iraq exemplify the three types of reaction.

Kuwait: Getting Out

During the 1970s, the Kuwaitis had been among the more imaginative of the rich Gulf states. Rather than spend the bulk of their cash on public works and subsidies, they had set aside \$100 billion in two huge reserve funds to finance the needs of future generations. Many of these funds were invested in stocks abroad: British Petroleum and Hoechst metals, to name a few. In the 1980s, the Kuwaitis discovered they were actually earning more from these investments than from oil exports.

That discovery suggested a way for Kuwait to deal with the crisis of the Arab state system. Kuwait's rulers dreamed of turning their country into a Middle Eastern analogue of South Korea: economically linked to the West and defended by American power.

Economically, the Kuwaitis decided to expand and consolidate their investments in the West. For this, they



from the Arab state system. They began to rely more on an American security umbrella. In some ways, they were returning to the conditions of the 1960s, when Great Britain protected the Gulf states from their hungry neighbors.

The poorer Arab states were not happy about that development, and their resentment toward Kuwait and the rich states grew. They had no big cash assets; they faced an immediate economic crisis. Their choices were exemplified by Jordan.

Jordan: Economic Austerity

In 1988 conditions in Jordan were already desperate. The country needed \$700 million in hard currency each year just to service its foreign debt and another \$800 million to cover its trade deficit. Aid from Arab states, which had run \$2 billion annually in the early 1980s, had dwindled to less than \$200 million a year. The economy was slowing and the dinar was losing its value.

By early 1989 the Jordanian government no longer had enough money to keep repaying its debt. It was forced to turn to the Paris Club to arrange rescheduling. But the Paris Club would not act until the International Monetary Fund certified that the Jordanians were taking measures to strengthen their economy. So Jordan

had to negotiate with the IMF, which insisted upon its usual austerity program: the currency had to be devalued, the budget cut, and consumer subsidies eliminated.

In April 1989 Jordan began to implement the austerity plan, announcing massive cuts in public spending and increases in the prices of cigarettes, gasoline, electricity, milk, and bread. The immediate result was a week of the worst rioting the kingdom had ever seen.

To halt the rioting, King Hussein sacked his prime minister and promised new elections. When the elections were held that fall, radical Islamist candidates won a clear plurality.

In most of the poorer Arab states, energetic Islamist movements wait in the wings. The oldest opponents of the Arab state system, they have developed an elaborate ideology that criticizes the ruling elites for their foreign ties, their corruption, and their injustice to their down-trodden subjects. They are experts at grassroots organiz-

needed more cash fast. They drastically reduced the aid they dispensed to their foreign neighbors, rebuffing Jordanian requests for emergency economic assistance and notifying Iraq that they still expected repayment of more than \$10 billion lent during the war with Iran. They increased their petroleum exports, exceeding their OPEC production quota and driving down the price of oil, in a frantic search for cash.

Politically, too, they began to contemplate closer ties with the West. They believed that Iraq, in the end, had failed to defend them from Iran. Instead they thought that America, through its agreement to reflag Kuwaiti tankers and its naval intervention in the Gulf, was the force that cowed Khomeini. They paid less attention to the Arab League and more to the Gulf Cooperation Council, a regional security alliance fostered by Saudi Arabia. They began to admire the Saudi "special relationship" with the United States.

The Kuwaitis, and other Gulf regimes, began to exit

Saddam could have gotten most of the concessions he wanted from Kuwait through a few military maneuvers on its border and some hardball negotiations. But he knew that the process would be long and painful. He decided instead to gamble on resolving all these problems at once with a demonstration of his power: he invaded Kuwait.

ing, using mosques, medical clinics, and student organizations to propagate their program. They are not generally hidebound clerics like the Iranian ayatollahs, but young postmodernists who rejected Western culture after flirting with it. They are dedicated and effective.

The Islamists are a significant force in most Arab countries and are well positioned to exploit the anger aroused by economic adjustment programs. They prospered in Tunisia and Morocco after the bread riots of 1984, took power in the Sudan after the economic collapse of 1985, and swept the municipal elections in Algeria after the government adopted an economic austerity program in 1988.

Obviously economic adjustment is so dangerous a policy that Arab leaders have adopted it only when all other choices are closed. Some Arab states, like Egypt, Algeria, and Iraq, still have enough influence in regional affairs that they have been able to attempt a different strategy: to try to reconstruct the Arab state system. That is what Iraq has been attempting to do.

Iraq: Rebuilding a Streamlined System

Despite its domestic oil resources, Baghdad needed as much economic help as any of the poorest Arab states. Iraq had spent more than \$241 billion prosecuting war with Iran (more than it had earned from oil exports since they began in the 1930s) and needed billions more to repair the damage. It had already borrowed heavily, and

repayments on foreign debt consumed more than \$4 billion a year. Iraqi citizens, having tolerated austerity during the war, insisted on a tangible increase in their standard of living.

Saddam Hussein desperately wanted to keep the Arab state system alive. He told his richer neighbors he still deserved their aid because his army kept Iran at bay. He began to hint that he would use his military to challenge Israel, if only the other Arab states would continue to foot his bills.

At first he put his case across peaceably. He recruited Egypt, Jordan, and the Yemen to join him in forming an Arab Cooperation Council to lobby the rich Arab states for more aid. To lend credence to his campaign, he began to cultivate ties to the poorest groups of Arabs: Palestinians in the refugee camps, Mauritians, the Sudanese.

But his entreaties went unanswered. The Kuwaitis and the United Arab Emirates continued overpumping oil, undercutting his revenues. The Saudis and Kuwaitis refused to forgive his debts. By May 1990 Saddam had changed his tone and suggested that if the Arab state system could not be held together voluntarily, he would hold it together by force.

Saddam could have gotten most of the concessions he wanted from Kuwait through a few military maneuvers on its border and some hardball negotiations. But he knew that the process would be long and painful and that it would be followed by slower negotiations with the Saudis, and even more laborious talks with the distant emirates. He decided instead to gamble on resolving all these problems at once with a demonstration of his power: he invaded Kuwait.

In one way, the Iraqi invasion of Kuwait eased the crisis of the Arab system: it doubled oil prices. But even in the richest Gulf states, the doubling of oil prices will not create the kind of funds that might be used to resurrect the old Arab state system. In real (inflation-adjusted) terms, the price of oil still stands below its 1980 level. Yet the price of security in the Arab World has risen dramatically.

Saudi Arabia, for example, may earn a \$25 billion windfall from oil exports over the next year. But the prospect of a Gulf war has also scared off an anticipated \$10 billion of foreign investment. The kingdom may already have spent \$8 billion to \$10 billion resettling 200,000 Kuwaiti refugees, bailing out local businesses distressed by the crisis, and defraying the costs of Asian workers fleeing the Gulf. It will also spend more than \$10 billion supporting the American military deployment in the region.

Since the invasion, the Saudis have wrestled with the same security dilemma that confronted the Kuwaitis. Some figures inside the royal family think that the American deployment itself foreshadows the solution of their security problems. They are trying to entice Washington into making a long-term commitment to the kingdom, involving permanent bases, more advanced

weapons for the Saudi armed forces, and a formal military alliance of the two countries. To make themselves a more attractive ally for America, they have toyed with the idea of creating quasi-democratic institutions.

But a permanent American presence in the Gulf frightens many in the region. The Iranians and Syrians have already announced that, over the long run, they consider American troops more of a threat than Iraq. Many Arabs would see such an alliance as an exercise in old-fashioned imperialism, with America allying itself with local despots to preserve its access to oil. Even conservative Saudis are worried about the local social changes that might be galvanized by an intimate relationship with America.

Thus other members of the Saudi royal family would rather limit the kingdom's American entanglements and rely instead on Arab allies for its security. They have been delighted that Egypt, Syria, and Morocco have contributed troops for their defense. They note that while America can deter formal armies from invading the kingdom, other Arab states can do more to protect it from subversion by tribal guerrillas, emigré dissidents, or military cabals.

Plenty of states are willing to supply *condotierre* for the Saudis. At the beginning of 1990 Egypt was immersed in a paralyzing economic crisis and was contemplating an IMF-dictated austerity program. Cairo's solidarity with Saudi Arabia in the Gulf crisis has earned it direct aid from the Gulf and forgiveness of \$7.1 billion in American military debt, and revenues from its modest oil exports have risen. But that does not mean that Egypt will enjoy the kind of prosperity it had during the heyday of the Arab state system. Its increased revenues barely offset the costs the Gulf crisis has imposed on Egypt: the loss of billions of dollars in income from emigré workers in Iraq, tourist receipts, and Suez Canal tolls.

Many of the oil-poor Arab states have been hit much harder than Egypt. A million Yemeni workers, who supplied most of their country's hard currency, have been sent home from Saudi Arabia. Jordan has been devastated. Over the next year Amman is expected to lose \$660 million in Iraqi debt repayments, \$250 million in transit business, \$230 million in tourist business, and \$180 million in oil grants. The total bill is projected to be \$2.1 billion — more than half the country's gross domestic product. Many observers fear King Hussein may lose his throne before Saddam Hussein loses his.

It is always dangerous to make any predictions about the Middle East. But in conditions of economic collapse, dissolving security arrangements, and rising domestic discontent, it seems a safe bet that the region is heading into an era of renewed turmoil. Coups, interstate feuds, and even Islamist revolutions seem likely prospects.

Potentially the most unstable state in the region is Iraq. We do not yet know how much damage the international embargo and the looming war may do to the country, but it is clear that Saddam Hussein has commit-

ted economic suicide. Baghdad has already lost its oil receipts for this year and swallowed the costs of another massive military mobilization. So long as Saddam is in power the country cannot expect rescheduling of its debts, much less new loans. And foreign firms, critical to Iraq's planned reconstruction, are unlikely to invest in a country where their employees might be made "guests by force" at any moment.

None of this bodes well for regional security. Traditionally, the Gulf states have played Iraq and Iran off against each other in a balance of power. If Iraq lapses into anarchy, who would offset the power of the Islamic Republic? If Saddam does survive, will he accept the mantle of Nasser and lead the oil-poor Arab states in another cold war against the Gulf monarchies?

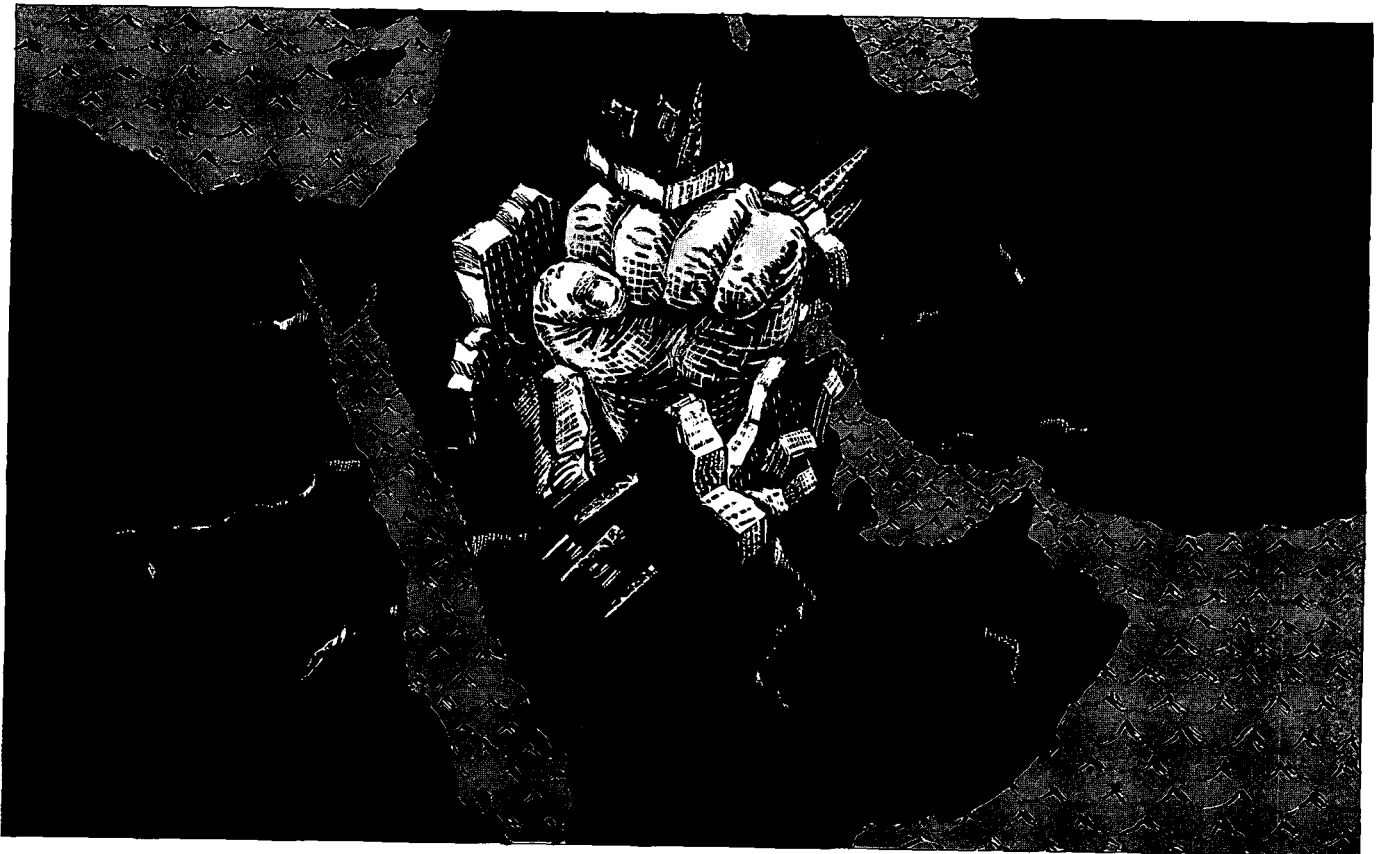
The United States did not create the current crisis in the Arab World. Even if the Iraqis withdraw from Kuwait, the crisis will not be over. Yet whether or not we go to war in the Gulf will have an effect, tempering or aggravating the imbroglio. If we urge Arab to fight Arab, we may revive the Arab cold war. Every Iraqi our troops kill will provide fresh ammunition for the Islamist campaign to expunge Western influence in the region. If we demolish Iraq, we may clear the way for a resurgence of Iranian power. There is no elegant solution for the crisis of the Arab system. We had better start thinking seriously about how we are going to live with it. □

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The Domestic Politics of Desert Shield

Should We Go to War? Who Should Decide?

Bruce W. Jentleson



If any evidence were needed that force is not obsolete in the 1990s, Saddam Hussein has provided it. The Cold War may be over, but the challenges to world peace and American interests are not.

And so the American political system wrestles again with those most fundamental questions of both foreign policy strategy and constitutional process. Should the United States go to war? Who should make that crucial decision?

We have been through this sort of debate before, and not always with encouraging results. Surely not during the Vietnam War, when politics were so bitterly polarized. Nor over Nicaragua and contra aid, when diplomacy between the White House and Congress all but broke down.

At first it seemed that this crisis would be different. More than 200,000 American troops were sent halfway around the world as a "desert shield" to protect Saudi Arabia against Iraqi aggression. The troop commitment was the largest by the United States since Vietnam and was the most rapid buildup since World War II. Yet in one opinion poll after another, through the first two months of the operation, public support was upwards of 70 percent. And the initial response on Capitol Hill was summed up by House Majority Leader Richard Gephardt: "In this crisis, we are not Republicans or Democrats. We are only proudly Americans. The president has asked for our support. He has it."

However, when President Bush announced on November 8 a doubling of U.S. forces to nearly 400,000 troops and a shift in strategy to insuring "an adequate offensive military option," the consensus began to crack. Congressional leaders became much more critical, public opinion polls fluctuated, and the first teach-ins sprang up on college campuses. Around the country there was an increasing sense of being on the brink of that most crucial decision a nation can face.

Whether to Use Military Force

The principal initial mission of Operation Desert Shield, as the president had made emphatically clear, was one of crisis deterrence and emergency defense against the threat of an Iraqi invasion of Saudi Arabia. The Bush administration had been quick to impose economic sanctions against Iraq for its invasion of Kuwait, but the decision to send American troops was made six days after the invasion of Kuwait and only when Iraq appeared primed to extend its aggression into Saudi Arabia. It was hoped that this show of force might add to the sanctions and help compel Iraq to withdraw from Kuwait, but the primary mission was to

deter and, if necessary, defend against an invasion of Saudi Arabia.

The 70–80 percent support in public opinion polls was higher than at any point during the Vietnam War. And at a White House briefing for 170 members of Congress, President Bush "was personally commended by speaker after speaker," according to House Speaker Thomas Foley. "There were really no overall reservations expressed." Even Newt Gingrich, the House Minority Whip who could find nothing good to say this fall about the president's stands on taxes and the budget, expressed "a sense of awe at how brilliantly Bush has handled this."

There could be little question that the American body politic was demonstrating a will at least to threaten to use military force that had not been in evidence since the Vietnam War. The aversion to military force left by that conflict and its aftermath had been such that polls in the late 1970s actually showed a plurality of the American public unwilling even to defend Western Europe against a Soviet invasion.

The 1980s had seen some increased willingness to use force, though the support for force was often hedged. And sometimes support was withheld altogether, as in the case of Nicaragua, where U.S. public opinion stoutly resisted the blandishments of Ronald Reagan and opposed even aiding the Nicaraguan contras as surrogate instruments of force. The 1983 Grenada and 1989 Panama invasions — quick, successful, and low-cost (at least in terms of U.S. lives lost) — drew strong, but largely after the fact, support. No pollsters ever thought to ask about Grenada before the invasion took place, and the pre-invasion polls on Panama showed only about 30 percent support for an invasion. In at least two cases, the 1986 military action against Libya for its role in international terrorism and the 1987–88 reflagging of Kuwaiti oil tankers and accompanying naval confrontation with Iran, the polls did show strong public support. Even before the bombing of Libya, support for proposals for military action averaged a 65 percent approval rate. Although the Kuwaiti reflagging roused some opposition in Congress, the dissent was never strong enough to constrain the operation, as it was in the case of Nicaragua.

The strong initial support for an operation of the sheer scale of Desert Shield is the most striking manifestation yet of a U.S. willingness to put Vietnam behind it and to support the use of military force. That the primary objective has been to restrain international aggression has been crucial to the support it has generated. A great deal of reticence clearly remains — the support for the Panama *fait accompli* notwithstanding — when it

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comes to using force to overthrow governments. When confronted with actual aggression, U.S. public opinion shows both a clearer sense that vital interests are at stake and a much stronger conviction of the legitimacy of action. The Iraqi crisis has been perceived as very different from Vietnam or Nicaragua, where the legitimacy of the American involvements was so much in question amidst the ambiguities of distinguishing Vietcong from North Vietnamese army regulars and of searching for strands of evidence of Sandinista gun running. The Iraqi invasion of Kuwait was about as blatant an act of aggression as one finds in international politics: tanks had rolled, troops had marched. Iraq was threatening to extend its aggression, and this time to Saudi Arabia, a country whose security was on the short list of U.S. vital interests.

But even the high level of initial support was never an unconditional endorsement for any and all U.S. military action against Iraq. Rather, as table 1 shows, it was based much more on the deter-and-defend Saudi Arabia mission, and on some sentiment for retaliating if American hostages were harmed, than on an objective of militarily pushing Iraq out of Kuwait, or directly attacking Iraq. The polls in table 1 show a definite pattern: public support was highest for defending Saudi Arabia, also very high for retaliating if American hostages were harmed (an issue made moot by their recent release). Approval fell noticeably for militarily forcing Iraq out of Kuwait and fell even lower for going after Saddam Hussein or otherwise taking direct military action against Iraq.

This differentiation by the objective for which military force is to be used also helps explain the fluctuating overall approval ratings seen in figure 1, which shows public support for Desert Shield through late November. Overall support held quite steady at around 75 percent through August and September. The drop-off to an average of 61 percent in early October was due largely to fallout from the other great battle of the day, the one being fought out (and rather haplessly so) at home over the federal budget. While down from the previous month, Bush's approval on Desert Shield was stratospheric compared with approval of his handling of the economy (36 percent), the budget (29 percent), and the savings and loan crisis (26 percent). Once the budget battle was over and with President Bush shifting attention to the Iraqi crisis as he campaigned for Republican candidates in the two weeks before the election, election day exit polls showed public approval for his handling of the Iraqi crisis back up to 67 percent.

But support fell again, and this time more substantially, to an average of 53 percent, in the polls taken in the weeks after Bush's November 8 strategy shift. Much of the ensuing commentary has been about how public opinion had shifted. In fact, though, it was the Bush strategy that was doing the shifting. Army divisions were going from four and a half to eight; the number of tanks from 800 to 1,200; the Marines from one expeditionary force to two; the Navy from three to six aircraft

carrier groups; the Air Force from 500 to about 1,200 aircraft; and three Army National Guard units were to begin desert training. And while offensive options had never been denied before, they now were being openly articulated by the president — and being prepared for on the ground, at sea, and in the air.

As table 1 shows, the public had had doubts about offensive military action all along. What they had been strongly supportive of was defending Saudi Arabia. Yet this threat appeared, at least for the moment, to have been defused; Desert Shield had achieved its most immediate objective. But while the public supported the objective of an Iraqi withdrawal from Kuwait, they had never been sure that military force was the best way to achieve it. And while they had no affection for Saddam Hussein, they still were not very supportive of attacking him or his military complex. The one partial exception, with 54 percent support in a *New York Times*–CBS poll, was military action intended “to stop Saddam Hussein from developing nuclear weapons.”

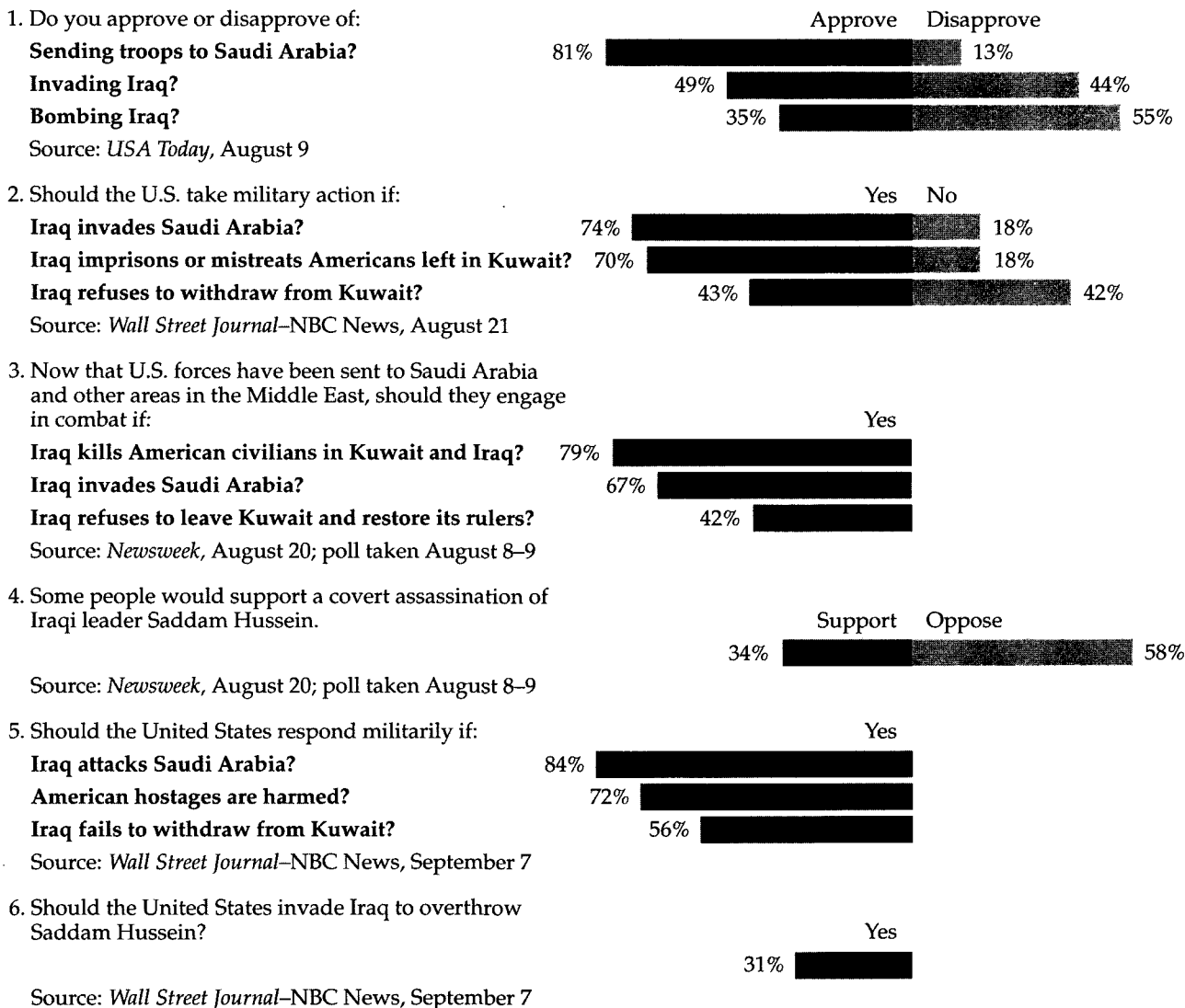
Opinion polls conducted in late November, after the Bush administration launched a new diplomatic initiative, showed some recovery, to an average of 59 percent public approval. But while support levels again were fluctuating, the message was the same. The public wants the Bush administration to pursue a nonmilitary solution if at all possible. Americans are, at most, prepared to support military force to get Iraq out of Kuwait only as a last resort.

A comparable pattern has been evident on Capitol Hill. Congressmen have raised few questions about the need to deter an Iraqi invasion of Saudi Arabia, and, if necessary, to defend against one. Even before the president had decided to send troops, House Speaker Foley warned that an Iraqi attack on Saudi Arabia “would call for a direct military response by the United States.” Congressional delegations have traveled to Saudi Arabia and personally reassured U.S. commanders and their troops of their support. In more concrete terms, and other budget battles notwithstanding, Congress readily approved the \$2 billion supplemental appropriation for covering the costs of Desert Shield.

On Kuwait, while Congress has stood strongly behind the objective of an Iraqi withdrawal, its earnest preference has been for sticking to diplomatic tracks. In the House resolution, passed overwhelmingly on October 1, declaring general support for Desert Shield and affirming the objective of “the immediate, unconditional, and complete withdrawal of all Iraqi forces from Kuwait,” Congress stated quite explicitly its support for “the President’s emphasis on *diplomatic* efforts,” and directed that “the United States shall continue to emphasize the use of *diplomatic* and other *nonmilitary* means while maintaining credible United States multinational *deterrent* military force” (all emphases added).

There has been even less support in Congress for the various total victory schemes that have been floated. The Bush administration has yet to acknowledge the to-

Table 1. Public Opinion Polls on Operation Desert Shield



tal defeat of Iraq as one of its objectives, and most of the calls for war sooner rather than later have come from ex-government officials and prominent strategists on the op-ed pages, such as Henry Kissinger. The one Bush administration official who publicly discussed a direct attack on Iraq, Air Force Chief of Staff General Michael Dugan, was summarily fired. Few doubted, though, that General Dugan's crime was speaking publicly about what others in the administration had at least discussed, if not requested contingency plans for. The House resolution of support for the president's policy thus did affirm the need to contain Iraq's military development, especially nuclear and chemical, but urged that it be done by "continuing to seek international consensus."

The key point is that these varying levels of support for the different military options have been there all along, but remained scarcely noticeable in the background as long as the primary mission was to deter and

defend Saudi Arabia. But with the added buildup and the articulation of a potential offensive strategy, they have come to the fore.

The reasons for these differentiations are important to understand. First is differences in the anticipated costs of each military option, in particular the likely casualties. There are no guarantees of any easy military options in the current situation, but defending Saudi Arabia likely would have the fewest casualties. The American troops are mostly stationed along a second line of defense, with Saudi and other Arab troops in the multinational force stationed along the border with Kuwait. Positions are well fortified and well supported by armies and air defense.

Retaliation against Iraq for any harm done to the hostages, however, would have been riskier, both for the military forces and for the hostages, held as they were as "human shields" at strategic sites. As to any rescue op-

Figure 1.
Public Approval Ratings of President Bush's Handling of the Iraqi Crisis



eration, it was hard enough when, as in Iran in 1980, the hostages were all together.

The greatest risks appear to lie in launching military operations to force Iraq out of Kuwait. Neither Congress nor the public has been persuaded by the can-do confidence of General Dugan and others about surgical air strikes and the technological superiority of night-vision equipment and other sophisticated weaponry. "Most of our 'wonder weapons,'" notes the highly regarded military analyst Harry Summers, "which work perfectly on paper, have never been tested in battle."

A direct attack on Iraq might have lower direct casualties, but could entail significant political costs. The international coalition could fall apart, if Arab countries such as Saudi Arabia and Egypt needed to separate themselves from an attack on even this Arab brother, or if the Soviet Union or France recalculated their own geopolitics. And one can only speculate what Saddam Hussein might do in retaliation. He might lose, but he would be apt to try to take his toll on the way down.

A second consideration goes back to the point made

earlier about public support for force being rooted in a conviction of its legitimacy. Americans are more receptive than they were a few years ago to using force to restrain aggression, but they remain reticent about using force to remake governments. Even against Muammar Qadhafi in 1986, and even when the polls showed such strong support for retaliating for his terrorism, there was much less support for getting involved in attempts to overthrow or assassinate him. Thus, George Bush's comparisons of Saddam Hussein to Adolf Hitler notwithstanding, public and congressional support for "getting Saddam" remains low. Sentiment might change after the fact, and if it were successful, as with Noriega in Panama. But that would be the chance the Bush administration would have to take.

Who Decides to Use Military Force?

In its entire history the United States has declared war only five times. It has, however, used or threatened military force in one form or another more than 200 times. The reason is that the constitution divides war powers between the executive and legislative branches. Only Congress can declare war. But the president is commander in chief of the armed forces. In the republic's early years presidents freely used the armed forces for minor skirmishes — warding off pirates, for example — in this hemisphere and elsewhere. As U.S. power grew, so did the scope of the undeclared "war making." Both the Korean and Vietnam wars were waged without being declared.

The 1973 War Powers Resolution was supposed to resolve the dilemma. The resolution limited to 60 days — with a possible extension to 90 days — the commitment of American troops without congressional authorization or a declaration of war. That the resolution has not solved the problem of divided war powers is clear enough from the current crisis. More than 400,000 American troops are being air and sea lifted halfway around the world on an emergency basis in the wake of an invasion of one country and amidst fears of an invasion of another. Those troops are now poised to square off against a million-man army commanded by a brutal dictator and armed with chemical and possibly biological weapons. Yet the president has refused to invoke the War Powers Resolution. And Congress has gone along with him.

Senator Claiborne Pell, Chairman of the Senate Foreign Relations Committee and an original sponsor of the War Powers Resolution, stated back in August that a debate on the resolution "would upset the apple cart." House Foreign Affairs Committee Chairman Dante Fascell, also a sponsor of the original resolution, put down efforts by some members of his committee to invoke it. Both chambers assiduously avoided what Fascell called "the W.P. words." The overriding concern at the outset of the crisis, as forcefully stated by Senate Majority Leader George Mitchell, was that "insofar as Saddam

Hussein and the government of Iraq are concerned, they should be aware that the American Congress stands squarely behind President Bush."

So the House passed its joint resolution of support, by a vote of 380–29, and the Senate passed a comparable one, by the even more overwhelming vote of 96–3, putting both chambers on record — for Saddam Hussein and others to see — in support of the president's policy. Congress also took such other moves increasing presidential discretion as granting the administration's request to extend from six months to one year the period for which the president can call up combat reserves or National Guard units without declaring a state of national emergency.

Yet herein lies the essence of the war powers dilemma. On the one hand, in a crisis such as this, the credibility of American power requires that there be a firm national will to carry out the threats the president makes. If an adversary is to be deterred, and especially if he is to be compelled to reverse himself, he must be convinced that noncompliance has consequences. Moreover, allies who themselves are incurring risks by joining in the multinational coalition must be reassured that as they come to join the United States, we will still be there.

On the other hand, the whole problem that the War Powers Resolution was intended to address, as has been noted by Brookings scholar Robert Katzmann, was "to affirmatively define the congressional role from the start, when the president first contemplated military activity." The lesson of Vietnam and elsewhere was that military involvement was much harder to reverse once begun than to prevent from the outset. Thus in the resolutions it passed, Congress tried to strike a balance between supporting the president's declared policy but not giving any Tonkin Gulf–like blank check for any and all future actions he might choose to take. "This resolution does not," Senator Pell emphasized, "I repeat — does not constitute authority for the President to initiate unprovoked military action against Iraq." But it did not limit that authority either. It sidestepped, rather than confronted, the core question.

One can, of course, continue the debate over whether the conditions established in the War Powers Resolution pertain to Desert Shield. But that only further makes the point of the inadequacies of the resolution. Presidents may, as President Bush did, report to Congress within 48 hours of beginning the troop deployment (one of the resolution's "clocks"), but pointedly state, as President Bush also did, that this was "consistent with," not as required by, the legislation. The president denied that "hostilities" were imminent (the triggering language in the resolution), but then a few weeks later authorized higher salaries for the troops in Desert Shield according to the Pentagon's imminent "danger" pay scale. And while Bush acknowledged that the troops "are equipped for combat" (another triggering phrase), he stated that "their mission is defensive."

This is by no means the first time we have played this lawyerly game. We have spent almost 20 years in more than 20 situations debating what hostilities are (did the Marines being fired on in Beirut in 1982–83 qualify?) and when they are "imminent" (Iranian attacks on American naval ships in the Persian Gulf in 1987–88?), as well as what is a "possible instance" when consultation can or cannot take place (Grenada? Panama?) and whether that consultation must be before or can be during or after the military action is initiated (once the bombers were on their way to Libya, but before they dropped their bombs?), as well as how many troops it takes to "substantially enlarge" a U.S. presence (how about 200,000?).

The reality is that every one of these terms is, to use Edward Corwin's classic phrase, an "invitation to struggle." And institutional positions in that struggle usually determine constitutional interpretations. Presidents always claim that the War Powers Resolution doesn't apply: Jimmy Carter didn't like it any more than Ronald Reagan did. Not all members of Congress embrace it, but most feel quite strongly about their institutional prerogatives, especially on such important matters as war and peace.

Of course, the option was there in 1973 — and is there today for those who would rewrite the War Powers Resolution — to use tighter and more precise language. One could, for example, define hostilities as the firing of any first shot at an American and state that U.S. involvement in hostilities becomes imminent as soon as an American is within range of an enemy's weapon, say 50 feet for a gun, 10 miles for a bomb, 100 miles for a missile. Such language tightening, however, presents its own prob-

U.S. troops are now poised to square off against a million-man army commanded by a brutal dictator and armed with chemical and possibly biological weapons. Yet the president has refused to invoke the War Powers Resolution. And Congress has gone along with him.

lems: taking too much discretion away from a president and tying his hands too tightly.

The point is that no statutory solution, no legal terminology, no wordsmithing can fully rationalize, regularize, make predictable, or otherwise legislate the war powers relationship between the president and the Congress. The reason is that war powers are not just a statutory issue, but also necessarily a political one.

That is why genuine consultation by the president and his key officials with congressional leaders — not just reporting and not just testifying, but dialogue and deliberation — is so important. Presidents need to stop seeing consultation with Congress as a problem to be avoided. If the president decides to take the step to use military force, and unless he can be sure to deliver a Panama-like low-cost quick and out operation, he is going to need congressional support. Congress is more inclined to support the president when it feels it has been kept informed, has been consulted, and, especially after the Reagan years, has been treated with respect.

Equally important, as the president considers such momentous decisions, he should hear from the congressional leadership. He should do so not just because it is consistent with the principles of our representative system of government, but also because it is consistent with sound decisionmaking. American foreign policy is riddled with failed policies that came out of closed decisionmaking: the Bay of Pigs, Vietnam, the 1980 hostage rescue in Iran, to name a few glaring examples. It is not necessary for 535 members of Congress to be directly involved, but it is both smart politics and sound decisionmaking to involve the congressional leadership.

Even the White House belatedly acknowledged that failing to consult Congress before its November 8 shift in strategy was at minimum a big political mistake. We “brought ourselves some of this turmoil,” one senior official admitted. The irony was that the Bush administration had started out doing a reasonably good job of consulting with Congress. Early on, both House Speaker Foley and Senate Majority Leader Mitchell praised the administration for keeping them informed. One member who participated in a White House meeting commented approvingly on how “Bush opens the floor for questions and expressions of views.” But over time Bush appeared to be torn between his “open hand” and his presidentialist inclinations. In mid-October, as Congress went into recess, he refused a congressional proposal for a formal consultative group. He also refused to provide assurances that he would call an emergency session of Congress before initiating any military action. In an unusual move, Congress wrote a provision into its adjournment resolution empowering its own leadership to do so. And then came Bush’s own version of a “November surprise,” the doubling of U.S. troops announced just two days after the midterm elections.

The Bush administration clearly miscalculated both the public and the congressional outcry over this shift in strategy. The president may insist on calling it merely a

credible military option, but perceptions are what matter and it has been widely perceived as moving to a war footing. It is hard to argue, given our recent history, with those who are reluctant to accept at face value the claim that “the president knows best” — especially those whose children, husbands, wives, or other loved ones are at risk if we go to war.

Thus we are hearing calls for a national debate and even a special session of Congress. Yet it also is true that such a debate could detract from the pressure on Saddam Hussein. Here too it is perceptions that matter most, and we cannot ignore the risk that such a free-wheeling debate here could be perceived by Saddam as alleviating his own need to confront his own hard choices. This is why the “consultative group” proposals come closest to striking a workable balance. Perhaps the president will have learned a lesson from the backfiring of his November surprise and will work more closely and more genuinely with the congressional leadership as he considers the next steps for Desert Shield.

Looking Ahead

The American public and Congress are asking the president to answer convincingly three crucial questions before he decides to go to war. First, will the international community still be with us? Our position has benefited greatly thus far (both politically and strategically) from carrying the stamp of international legitimacy that comes with the support of the United Nations and with being the leader of a multinational coalition. But will the United Nations stand behind us if and when military force is actually used? The latest Security Council resolution is encouraging, but stops short of a definitive answer. And will the multinational coalition actually fight with us? Should there be casualties, “burden sharing” may take on an altogether different meaning than just budget shares and financial contributions.

Second, is military force truly being used as a last resort? Have all other options been tried? As to diplomacy, if Secretary of State Baker’s mission to Baghdad fails in spite of a good faith U.S. effort, the Bush administration at least will have a more credible claim that military force had become a last resort — although one would expect further eleventh-hour efforts as January 15 approaches.

Finally, there is much foreboding, and not just from peace groups but also from generals and admirals, about the casualties that war risks inflicting. The issue is not whether we can prevail militarily: it is at what cost. For all his diplomatic skill on the global front, George Bush has yet to foster the will at home to bear the burden that may lie ahead. He may be able to count on some rallying effect, but this will have limited staying power unless the president is able to make the case for war to the American people and Congress far more convincingly than he has thus far.

The toughest decisions are still ahead. □

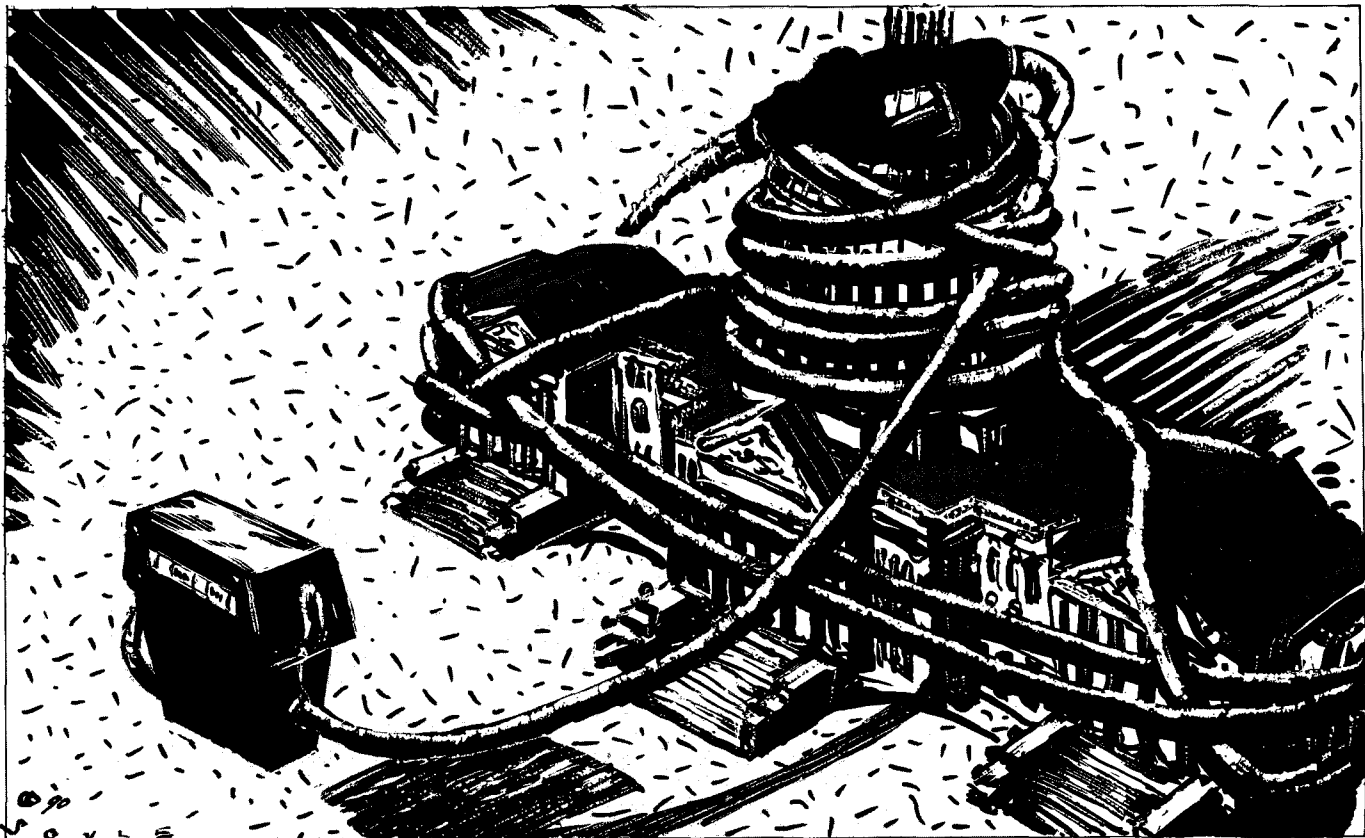
Déjà Vu All Over Again: Revisiting the Politics of Gasoline Taxation

Pietro S. Nivola

Amid tensions in the Persian Gulf, a new oil shock, and an election year, the president of the United States proposes roughly a dime-a-gallon increase in the federal impost on gasoline. The reaction on Capitol Hill is consternation. Some members stress that average gasoline prices have already risen 60 cents a gallon in recent months and conclude that motorists “have conserved about as much as they can.” Others accuse the president of plotting to generate revenues on the backs of the poor instead of the rich. And still others feel that with a recession looming, the administration is making a big mistake to raise any taxes at all.

Sounds a lot like October 1990 — except that the president is Jimmy Carter, the Gulf confrontation is with Iran instead of Iraq, and the year is 1980. The Carter gasoline fee was rejected overwhelmingly by Congress, whereas a comparable levy, endorsed by President Bush as part of this fall’s budget agreement, was first turned down, then chopped in half, and eventually adopted (grudgingly). Otherwise the political parallels are manifold. When it comes to taxing gasoline, anything more than a nickel ante is always too “painful.” And even a nickel can be cause for much congressional hand-wringing. The last tax hike (5 cents a gallon) was enacted eight years ago, in the Surface Transportation Assistance Act of 1983, but only after that legislation survived a two-week filibuster in the Senate and a razor-thin vote in the House, 197–194. In the preceding quarter-century, the House had defeated every proposed increase, no mat-

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ter how small, frequently by margins greater than 4-1.

Never mind that this routine opposition precludes an effective means of reducing the deficit, lowering harmful emissions into the atmosphere, and conserving energy. Never mind that the American economy is left unnecessarily vulnerable to international oil crises. Nothing now on the political horizon suggests that debate on the question of raising a stiffer gasoline tax is likely to improve.

Hitting the Road

Between the first energy upheaval in 1973 and the current one, U.S. reliance on foreign oil rose from 36 percent to 50 percent of total consumption. During the same interval, Japan's oil imports fell almost 25 percent. Needless to say, our heightened dependency cannot be ascribed to faster economic growth. (Japanese economic output more than doubled.) Nor can it be attributed to inefficient industry. Excluding from international comparisons the mining and fossil-fuel producing sectors, which are insignificant in countries like Japan, industrial energy usage has accounted for only a small part of America's uniquely heavy use of energy relative to gross domestic product. The main factor in that exceptionally heavy use, and in the growing demand for oil imports, is transportation. Americans pour into transportation more than half of all the oil they consume, compared with less than 30 percent for the Japanese and Europeans.

Why is transportation so energy intensive in the United States? The size of the country and the need to ship bulk commodities, such as ores, grains, and coal, over long distances are not dominant explanations. If anything, the freight modal mix is more fuel efficient here than in most other industrialized countries because of our large component of rail, pipeline, and waterborne traffic. Size and distance do influence passenger miles journeyed, but less than popularly supposed. More than 90 percent of all passenger miles are traveled by car, but most of the trips and total miles driven are attributable to urban, rather than intercity, driving.

That American cities are less densely settled than those of Japan or Europe is more significant. Greater urban densities are a precondition for the use of energy-saving public transit. Land use patterns, however, are not ordained by Mother Nature. It is true that mobility in urban areas with fewer inhabitants per square mile requires travel by automobile. But it is also true that building highways and failing to provide adequate public transportation to serve more concentrated development facilitates suburban sprawl. In any case, even a relatively dispersed population can achieve high levels of energy efficiency. For example, Swedish gasoline consumption per passenger mile has been only 60 percent of that in the United States, despite comparable density and living standards.

The bottom line is that comparatively low operating costs encourage Americans to own more cars per capita, to buy cars now averaging lower fuel economy than they

did two years ago, and to keep driving two to three times more vehicle miles annually than the Japanese and Europeans — or currently about one and a half trillion miles.

Free Wheeling?

These habits might be less troublesome if they were purely the result of market forces. But economic distortions, some abetted by government intervention, are involved.

With the Arab oil embargo in 1973, the nation suddenly became conscious of a major blunder: the automobiles rolling off American assembly lines were averaging fewer miles per gallon than the vehicles built in 1960. Despite the ensuing oil and gas shortages, not to mention potential inroads by foreign competitors, U.S. auto manufacturers kept plying the domestic market with products whose size, weight, and horsepower bore little resemblance to those of the rapidly expanding automotive industries abroad. Except for a brief surge in sales of domestic subcompacts in 1974–75, buyers continued to drift back to larger vehicles until 1979, when the same pattern began all over again: highly fuel-efficient cars made a comeback in 1980–82, but by 1990 General Motors and Ford were wheeling out new models with V-8 engines (like the 4,415-pound Buick “Roadmaster” that gets 16 miles to the gallon).

Were carmakers simply supplying what American consumers needed? Not entirely. Had it not been for petroleum price controls, which helped keep the real price of gasoline lower in 1978 than in 1972, motorists might have remained fonder of economy cars during the 1970s. In the 1980s, quotas on Japanese imports, whose fuel-efficiency averages exceeded Detroit’s, artificially inflated the price of the imports and ultimately induced the Japanese to start pushing bigger and brawnier models themselves.

The “needs” of customers have long been influenced by public policies at all levels. While we drive on highways financed by a special trust fund, the user fees and tolls in many places are not steep enough to cover the social costs of congestion, noise, and smog. Nor are the fees and tolls designed to offset the long-range welfare losses from global warming and periodic disruptions in world oil markets. Meanwhile, dependence on automobiles at the expense of other transportation modes has been fortified by a panoply of government programs that shape the use of urban land. Examples include federal tax benefits for homeownership; Federal Housing Administration and Veterans’ Administration

mortgage guarantees, covering one-fourth of all new single-family homes in the postwar period; grants for new roads and infrastructures in outlying communities; tax exemptions for development bonds to finance suburban industrial parks; and traditional local zoning and subdivision ordinances that discourage cluster developments better linked to transit lines.

The Worst Alternative (Except for All the Others)

A higher gasoline tax is not the only way to compensate for the enduring effects of a distorted market — and to lower the risks of oil dependency — but one thing seems increasingly clear: other fuel-conserving options have less to recommend them.

In 1975 Congress chose to adopt automobile fuel-economy regulations in lieu of a gas tax. Since then the Big Three automakers have periodically failed to meet the regulatory standards, largely because of strong demand for big cars during spells of soft world oil prices. Granted, today’s certified levels of 27 mpg on new-car fleets are a far cry from the 14 mpg recorded in 1974. Yet, the federal regulations have manipulated the market haphazardly, failing to address various flaws and even adding some new ones.

For example, the delay in setting standards for light trucks and vans created difficulties when sales of these vehicles leapt to more than 25

percent of the market in the late 1970s. Because the vans and pickups were lasting longer, were averaging only about 10 miles to the gallon, and were being used mostly for personal and recreational transportation (not business), they lowered the true overall gas-economy average of the passenger vehicle fleet. Moreover, because the government standards added to the expense of buying new cars, turnover in the total fleet slowed down, leaving more old gas-sieves on the road longer. So as of 1985, fuel efficiency for the whole on-road fleet — regulated cars, belatedly-regulated trucks, and older vehicles — was merely 2.7 mpg better than in 1973.

Regrettably, fuel-economy rules cannot immediately deliver the vast energy savings that are theoretically possible. The regulations attain savings only through replacement of the auto fleet, a slow process in which only 6 percent to 8 percent of all cars are scrapped in any one year. In the meantime, the rules have no impact on the amount of driving. By contrast, a gas tax encourages motorists not only to drive smaller

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cars, but to drive less, or differently. Ironically, in times of stable or declining gasoline prices, the mandatory fuel-economy program reduces the marginal cost of driving, enabling folks with smaller cars to drive more.

Another much-discussed alternative to a higher gasoline tax is a tariff on oil imports. Unless the main policy objective is to protect domestic producers from foreign competitors, however, it is hard to understand why policymakers keep entertaining this notion.

For one thing, friendly foreign sources, like Mexico and Venezuela, would likely be spared from the import duty. While this would help these reliable suppliers maintain access to the U.S. market, it could also leave us with a tariff that exempted most of the oil we import.

Assuming it were not riddled with exemptions, a tariff would cut U.S. use of foreign oil both by reducing domestic demand and by increasing domestic production. But should domestic oil companies receive, as they did in the 1960s, a subsidy through trade protection? The dilemma does not arise with an increase in the national gasoline excise, which neither subsidizes the oil industry nor contributes to renewed protectionism.

A gas tax is environmentally benign. Indeed, by limiting combustion of motor fuel, it curbs a leading source of air pollution. A tariff's environmental impact, on the other hand, would be mixed: consumption would decline, but domestic energy development projects would be stimulated and the use of coal could expand (since the relative price of oil would rise).

It is often asserted that the chief virtue of an import duty is that, unlike a levy on gasoline, it promotes conservation across *all* petroleum products and among all users. Broad-based taxes are usually preferable to narrowly based ones. And in any case, it is clearly desirable to adopt an energy conservation policy that is comprehensive.

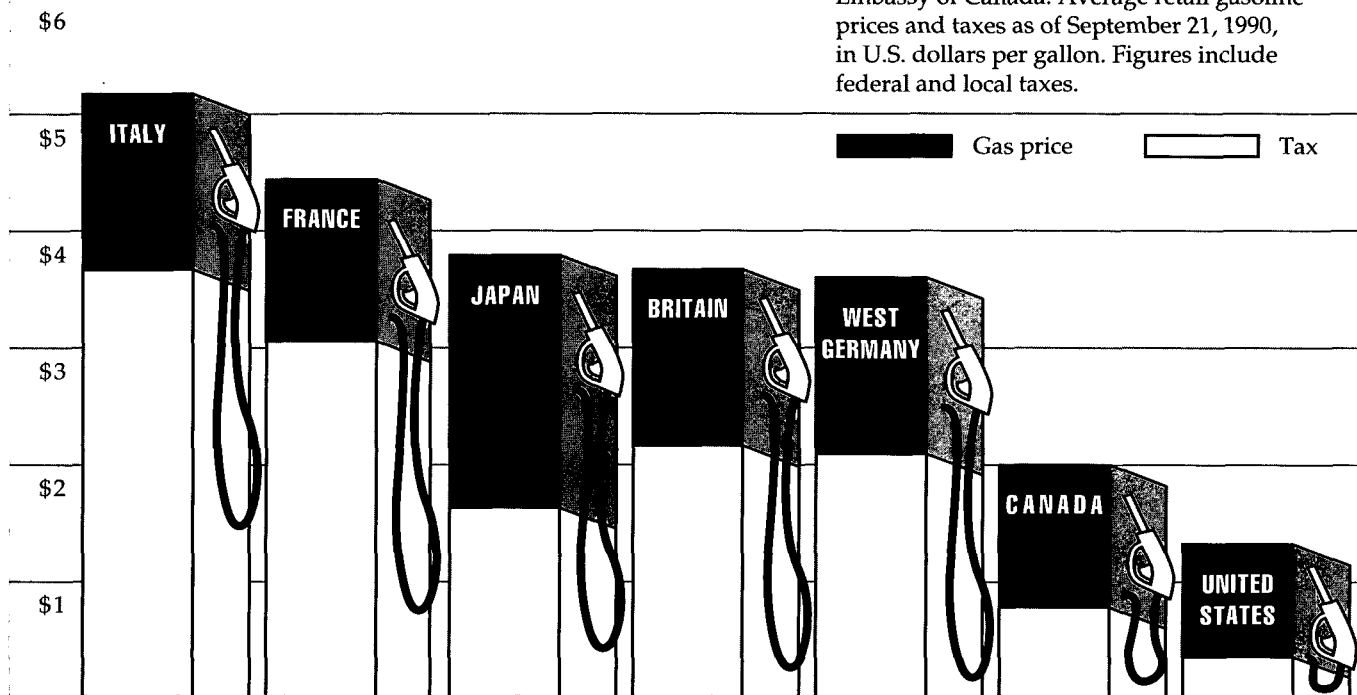
But an important purpose of a consumption tax on energy is to offset identifiable flaws or biases built into the marketplace, often because of government policies, past or present. By this reasoning the sectors that exhibit these defects, not the whole economy indiscriminately, ought to be the target of the tax. A compelling case can be made that the pattern of fuel consumption in transportation calls for remedial tax policy. Why penalize everything else, including industries where the most impressive savings are being realized through existing price pressures? Policymakers should bear in mind that an across-the-board surcharge on oil, unlike a tax limited to gasoline, could put some key U.S. export industries, heavily dependent on petroleum-based feedstocks, at a greater disadvantage in international competition.

Veto Groups

If taxing gasoline makes sense, why does Congress agonize over it?

One explanation is that few, if any, organized interests have an incentive to lobby for this type of energy tax, whereas many have incentives to assail it. Notice, again, a key distinction between a gasoline levy and an

Figure 1. International Gas Prices and Taxes



oil tariff: because the tariff shelters the domestic petroleum industry, domestic oil producers often not only welcome the protection but actively campaign for it. Even when the oil patch finds trade barriers inexpedient, tariffs may gain favor with suppliers of competing fuels. (Higher prices for petroleum can enlarge the market for natural gas and coal.)

A gasoline tax lacks allies among energy producers of any kind. Perforce, a decline in the use of gasoline does not lead to an increase in the demand for other fuels: automobile engines cannot be hooked to natural gas pipelines, nor can they run on chunks of coal. Hence, the tax offers coal and natural gas companies no clear opportunity to improve their market shares.

Meanwhile, as far as the petroleum industry is concerned, reduced demand for its principal refined product is bad news. Others think so too. Alongside the gasoline sellers will stand road contractors, engineers, truckers, taxicab companies, the nation's biggest automakers, and the United Auto Workers. State highway departments and state legislatures, which fear the loss of revenues from local tolls and excise taxes, usually join the fight. Perhaps most influentially, just about every congressional district bulges with service industries — motels, fast-food chains, shopping malls, and countless other roadside businesses — for whom patronage by motorists (and, at bottom, existence of inexpensive gasoline) is the lifeblood. Elected officials in other industrialized countries sometimes confront similar pressure groups, but never on the same scale.

Vox Populi

Opinion polls indicate that the public opposes higher taxes on gasoline by margins of 2 to 1 or better, regardless of how small the increase and regardless of whether oil is in short or ample supply when the poll is taken. This attitude about gas taxes might be all we need to know to explain their dismal legislative history, were it not for an obvious question: how do people in other democracies feel? Surveys in France, Britain, and Canada during the 1970s found that similar percentages disapproved of their governments raising the cost of petrol to conserve energy. Yet those governments proceeded to hike their tax rates to levels many times higher than that in the United States (see figure 1).

Maybe public hostility toward gasoline taxation impresses American congressmen more than it sways legislators elsewhere. British and Canadian MPs and French deputies might discount the polls because high

gasoline excises in those countries might entail fewer sacrifices. American lawmakers, on the other hand, may be viewing economical gasoline as a vital necessity that, like food, should be virtually tax exempt.

Detracting considerably from this hypothesis is the fact that, while congressional rhetoric characterizes gasoline as an essential commodity, the U.S. public's revealed preferences and responses suggest that demand for gasoline is quite elastic. Time and again during the 1970s, huge majorities indicated that higher prices not only worked but worked better than anything else in reducing gasoline consumption. Pollsters also found that Americans were more likely to react to a general rise in energy prices by cutting back on driving

than by, say, insulating their homes, or even turning off lights. Most interesting, a majority of drivers admitted they could cut back on their driving without great pain. When Gallup queried a sample of motorists in mid-1979 about the feasibility of giving up driving the equivalent of one day each week, 2 percent said they didn't know, 14 percent claimed it would be fairly difficult, 22 percent said very difficult, and 62 percent said not very difficult.

How much more onerous a gasoline price spike can be to Americans than to citizens of other countries (and how reasonably Congress can regard inexpensive gasoline as more indispensable to its constituents) is not easy to ascertain. U.S. households allot a larger share of their budgets to gasoline than do the Eu-

ropeans and Japanese. Maybe the burden for us is heavier; after all, our heavy consumption of automotive fuel is due in part to inadequate public transportation in many locations and to the decentralized structure of American metropolitan areas. But while gasoline is the most prominent energy expenditure to which U.S. consumers devote a larger share of their budgets than consumers in Japan and Europe, it is not the only one. American households spend more on almost every other kind of energy use as well. The basis of the difference in each instance is not that we "must" allocate resources in this fashion as much as that prices of energy have tended to be lower in the United States, so energy-consuming products of all kinds can be high on the shopping list.

Whatever our objective requirements, it is likely that, compared with foreigners, more of us complain when the price of gasoline jumps. The United States, after all, now has almost as many registered motor vehicles as there are adults in the country, and in recent years the number has been increasing nearly twice as

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fast as the population. Because vehicle owners are the group with the keenest interest in keeping down automotive operating expenses, and because ownership is so extensive, the public outcry against a substantial gas tax increase can be especially deafening here. Politically, the impact is magnified by comparatively low voter turnout in this country. Voter participation is highest among higher income groups, and the more income, the greater the number of cars a household is likely to own. In political systems where larger percentages of people vote, nonmotorists tend to figure more prominently in the active electorate.

Perhaps our most distinctive sentiment is a fixation with fairness. Throughout the 1970s solid majorities insisted that gas rationing was preferable to taxes as a means of restraining demand. Respondents regularly professed greater willingness to put up with the practical inconvenience, the red tape, and the strict curtailments associated with administered rations than to pay moderately higher prices at the pump. In 1978, for example, Gallup asked a national sample to pick between a rationing program that would require drivers to limit severely (that is, by one-quarter) the miles they drove and a tax that would add 25 cents to the cost of a gallon of gas. The outcome was striking: only 20 percent chose the tax. Why did people react this way? Apparently because rationing is perceived to be equitable, whereas fuel taxes are not. "It's that populism again," explained one congressman in a lengthy interview. "It's just the idea that it is a regressive kind of a national sales tax that is particularly hard on the little guy, who drives up to the pump and has to pay as much as the rich guy, who drives up in his Lincoln Continental or Cadillac." The congressman was in a position to know. He was former Representative John B. Anderson, whose outspoken advocacy of a hefty gasoline tax increase during the 1980 election proved politically disastrous.

From Bugtussle to Boston

"If this tax is enacted, we will be requiring the people of the heartland of America to carry this burden on both shoulders. It is unfair; it is inequitable; it is grossly discriminatory against the people of this country who do not have access to public transportation." The voice ringing through the House chamber was that of Democrat Bill Alexander of Arkansas, urging his fellow representatives to shred a gasoline tax plan that had come before Congress during the summer of 1975. Similar perorations could be heard every other time that

Congress took up gas tax legislation during the 1970s and early 1980s. And each time, legions of legislators from the heartland of America would chime in with a chorus of negative votes. That rural representatives would react this way was understandable. As Congressman Alexander asked, "Did you ever hear of anybody catching a subway in Osceola, Arkansas, or a bus in Bugtussle, Oklahoma?"

But members from places like Boston (where lots of people catch buses and subways) also behaved as if their constituents were living in Bugtussle. The vast hinterlands of the South and West have traditionally fought gasoline taxation, but to a remarkable degree, so have the extensively urban states of the Northeast. In a



1977 House roll call, for instance, the central-city congressmen from Boston, New York, and Chicago objected to a mere 4-cents-a-gallon boost by almost 2-1.

This geopolitical configuration might seem odd. Granted, the United States is an urban nation, and most gasoline is consumed where most people live — in metropolitan areas. (Close to 60 percent of all automobile travel takes place on city streets, with over half of all the trips covering less than six miles.) The bulk of a gasoline tax would be paid by residents of cities and suburbs. And when congressmen from less populous states, particularly in the West, protest about undue hardships, they don't usually call attention to the fact that many of their constituents have long enjoyed lower prices for other forms of energy, such as natural gas and electricity. Yet, it is undeniable that the per capita burden of gasoline taxation will be felt more acutely by people living in rural areas, where distances are great and alternative means of transportation are limited or nonexistent. So one would expect stronger regional biases for and against higher taxes.

Two reasons why congressional resistance is broad-based, rather than confined to particular states or re-

gions, have already been offered: the public is generally antagonistic toward fuel taxes, and hostile commercial interests are ubiquitous at the grassroots. There is, however, an additional element in the breadth of the anti-tax coalitions. Teaming up with members from rural or low-density areas who have a direct interest in holding down the cost of automotive fuel are those who dislike gasoline taxation on principle. Liberals say the tax is regressive, and many conservatives fear its revenues may end up nourishing big government.

Fair Enough

The creed on the Left is quite simple: taxes should rise with ability to pay, and sales taxation of automotive fuel doesn't qualify. The quest for progressivity seems, if anything, more intense today than it was back in the early 1980s, when the federal income tax system was being riddled with preferences for the wealthy. To Senator Don Riegle, for instance, the 5-cent gas levy proposed in 1982 was doubly "unfair and unwise" in the wake of the 1981 tax act: "the Government will be extracting the gas tax with one hand from low- and middle-income people, senior citizens, and others of modest circumstances, while, in mid-1983, the Government will be distributing a large tax cut to individuals of high income levels who neither deserve nor need this larger personal tax cut." But long after the 1986 tax reform had plugged many of the loopholes, including favorable treatment of capital gains, liberals continued to find no philosophical room for a gas excise. (The Democratic budget plan, passed by the House on a party-line vote last October 17, conspicuously omitted any gasoline tax.)

To be sure, the liberal crusade for fairness is selective. Lifting the price of gasoline is no more regressive in principle than raising prices on some other widely used items — like textiles and apparel, which Democratic lawmakers were overwhelmingly prepared to "tax" in a recent trade bill. Unlike an administered price for clothing, which would affect just about everyone except nudists, gasoline excise incidence is not indiscriminate; it falls primarily on groups who own the most vehicles and who drive them around a lot. Only half of all low-income families own cars, and those that do drive them about half as much as the national average. When motor fuel taxes are voted down, the loudest cheers may really come from well-off suburbanites with two or three gas guzzlers in the driveway. Nonetheless, legislators who cast those votes are often convinced they are striking a heroic blow for the disadvantaged.

Tax and Spend

To ideological conservatives, the virtue of taxing the sale of gasoline is also the defect. The instrument is visible, blunt, and so fiendishly good at raising revenue

that it invites the government to go on a spending spree. Even if all proceeds initially go toward reducing the budget deficit, sharp deficit reduction (which is what a stout tax could accomplish) is dangerous. Stanch the torrent of red ink tightly, says the Right, and what's to prevent incorrigible congressional spenders from returning to their old habits? Nor is there ever a right time to interpose the tax. When the economy is sailing smoothly, GNP growth shrinks budgetary shortfalls, so why rock the boat? And in recessionary interludes, it is folly, in Jack Kemp's words, to "worship at the shrine of the balanced budget."

Apart from these misgivings, conservatives believe that gasoline taxation is the domain of the states. A big federal incursion is tantamount to challenging states' rights. As one Republican senator explained during an earlier debate, it "takes away from the States their right to have control over their own excise taxes."

These arguments are interesting, but they don't speak to the main question: is it in the national interest to keep driving the equivalent of almost three million round trips to the moon each year? At a time of mounting concern about environmental degradation and renewed risks of international conflict over crude-oil supplies, not to mention frustration with persistent trade imbalances, such stratospheric levels of consumption seem, at best, insouciant.

Going Nowhere Fast

There may not be many lessons the United States needs to learn from the world's other advanced economic powers, but greater efficiency in the use of energy is decidedly one. No sector is in greater need of special attention than is automotive transportation, where waste could be reduced effectively through heavier excise taxation. But a bold increase in the federal motor fuel tax, which faces long political odds in the best of circumstances, cannot receive anything like a thorough hearing in today's polarized ideological landscape.

On one side, those who seek to shrink the public sector, or at least to transfer more of it from the national to the local level, prefer not to open a potentially enormous new source of federal funds. On the opposite side, those eager to pump up the federal fisc with revenues collected progressively pursue their own maximalism, ever professing to defend "the little guy," even at the risk of political gridlock. Thus far, pragmatists trying to maneuver the gas tax debate between these extremes have not been able to break free of all the other political obstacles. That they managed to rescue, after much huffing and puffing, 5 cents of a proposed 9.5 cent per gallon tax hike this past fall does not mean that the politics of gasoline taxation has turned a corner, only that very modest headway is all that the chaotic congressional traffic will bear. □

Television News and the Loss of Place

Stephen Hess

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What is most striking today about local television news across the country is its sameness. I say that with some confidence, having watched 106 broadcasts from 57 stations in 35 cities. True, the appearance of the programs will be glossier in the biggest cities, the anchors may be "salt and pepper" teams in racially mixed cities, and some sports like hockey are of more interest in certain places. But whether the news is from stations in Pittsburgh or Grand Junction, Colorado, Sacramento or Cincinnati, Albany or Salt Lake City, the stories are always the same. The parts are interchangeable. Absent is a sense of place, a sense that this news is special to this locale.

Look-alike TV is a legacy of the national consultants, who, during the 1970s, first created the "image" of Action News, Eyewitness News, News-Center News. All anchors now look alike. News desks look alike. Everyone sounds the same. I listened to anchors read the news on stations in Virginia, North Carolina, South Carolina, Georgia, and Florida without hearing a southern accent. These are broadcasters with their bags packed, poised to move up to the next market in some other part of the country. Their career profiles are remarkably similar to professional baseball players': Carolina League to Southern League to Triple A before breaking into the majors. Except you don't have to know much local history to cover second base for Winston-Salem.

Some suggest that the sameness of local news has something to do with the aspiration of local stations to go national, or even international. A *Newsweek* cover story, "The Future of Television," declares, "With their satellite picture feeds and resource-sharing consortiums, local news operations now have access to virtually any hot spot, be it in Nicaragua or the next state. By the time Rather and Brokaw deliver the story, the folks in Grand Rapids have already seen it all." But in 1986 I surveyed news directors at 102 stations, ranging in size from Philadelphia and Detroit to Presque Isle, Maine, and Twin Falls, Idaho, and found that they had no interest in expanding national and international news coverage. Only three news directors claimed that these nonlocal stories improved their standing in the all-powerful ratings war.

According to Lawrence W. Lichty and Douglas Gomery, "Local stations cover these stories to build the credibility of anchors and reporters. Virtually all of this effort is for promotional and personal reasons." Predictions that the stations will supersede the networks are going to be wrong. Stations want to be in the local news business. Everything else is a sidebar. And this is why the loss of place on the local stations is so disturbing. It's not that they want to be someplace else. It's that they don't seem to understand what's unique about where they are.

Perhaps local news seems the same because regionalism in America is being blotted out. Clearly, urban America is a condition that transcends individual cities. Americans are less likely to spend their entire lives in one location. Writes Joshua Meyrowitz, "In many ways, electronic media have homogenized places and experiences and have become common denominators that link all of us regardless of status and position." Nor is this without benefit. Forces that bind a nation together deserve to be promoted.

Still, Minnesota is different from Maine, Maine is different from Mississippi, Mississippi is different from Montana. And these differences are important to understand and report.

"My wound is geography. It is also my anchorage, my port of call," begins *The Prince of Tides*, Pat Conroy's novel of a Carolina sea island. Geography has always been an anchorage for Americans, even before there was a United States of America. Crèvecoeur, writing his *Letters from an American Farmer*, first published in 1782, compared the habits of "those who live near the sea," "those who inhabit the middle settlements," and those "near the great

woods," concluding, "Whoever traverses the continent must easily observe those strong differences, which will grow more evident in time." He was better at description than forecast. Yet nearly 200 years later Carl Carmer would look at the Hudson River and write, "Landscape has an especial influence on those who inhabit it — not merely in economic ways, as the wheat or cotton spring from the earth, not in geographic ways, as rivers and mountains become boundaries to be crossed, but in spiritual and psychic ways."

We do not expect this sense of place to be the province of network news. The networks report national events. They use the nation's regions only as backdrops for natural disasters (earthquakes, floods, hurricanes), or as the scene of elections for federal office, or as the locale of human drama, such as a little girl trapped in a well.

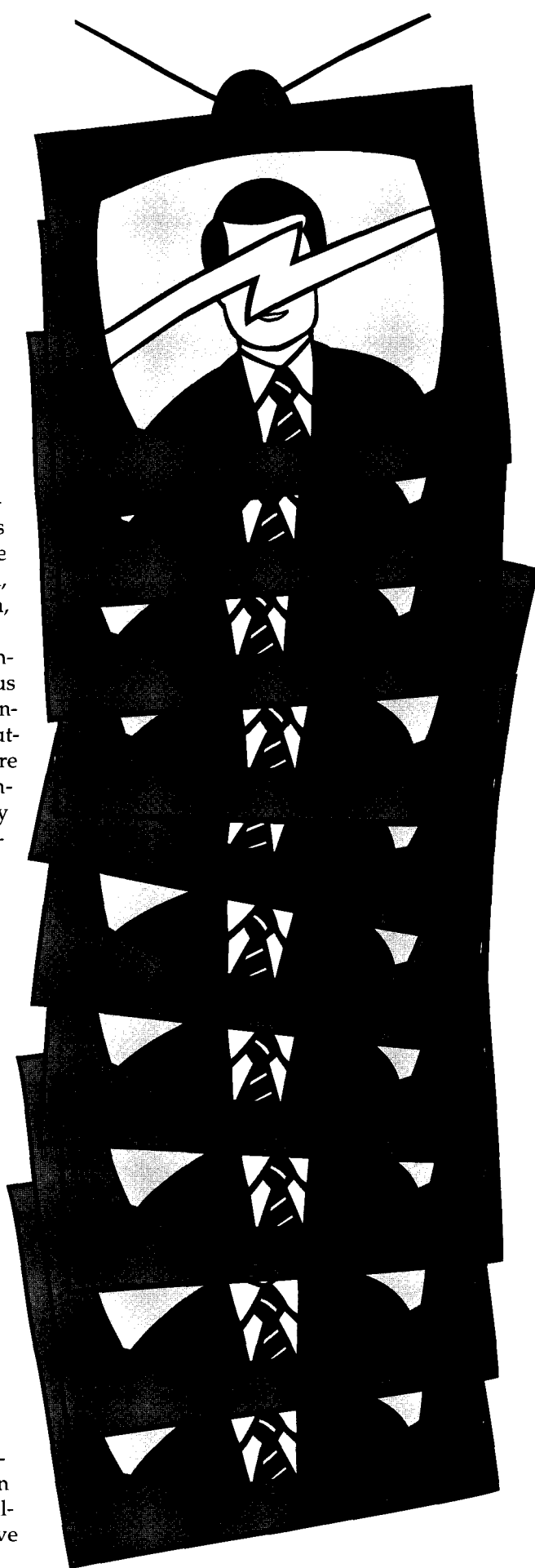
Public television, too, generally gives a cold shoulder to regional news, focusing almost exclusively on national politics and national policy. Its emphasis sharply contrasts with the intent of the Carnegie Commission on Educational Television, whose 1967 report, the motor force behind the present system, wanted public TV erected "on the bedrock of localism."

Cable TV was also expected to be a narrowcast medium. Indeed, some scholars initially worried that the multitudinous choices it would offer could lead to "members of closed and insular communities talking among themselves but not to outsiders." The choices on cable are there, all right. But they are mostly of old movies, pop music, sermons, and sports. A camera may be trained on meetings of the city council or county commission. Otherwise, the one thing that cable rarely provides is local news.

Even low-power TV, the 750 stations in the United States that have only enough transmitting capacity to broadcast in a 15–25 mile radius, are discovering that the way to profit is to hook up with a network. Typical of the programming being offered to low-power stations, says a *Wall Street Journal* article, is "a pet show in which celebrities talk about their pets."

Of all the sources of television news pictures, the only one likely to help us see the difference of place is our local stations. It is the one source that can make a healthy profit by stressing diversity.

All that happens in a community is not unique to it, of course. Mayhem and murder, the staple of news everywhere, are not necessarily different if they take place in Great Falls rather than in Grand Junction. But if journalists seek what makes one TV market different from all others, they will find themselves surrounded by example. Local history. Regional craft. Ethnic diversity. Recall the wonders of Calvin Trillin eating his way across the country in *America Fried*. Or, as a *New York Times* reporter noted, if the ham comes with a choice of gravy, "redeye made with coffee in the dripping or thick white sawmill style made with flour," you know you're at Aunt Eunice's Country Kitchen on Andrew Jackson Highway in Huntsville, Alabama. When we can turn on the local news and say to ourselves, "This has to be Tallahassee . . . or Tucson . . . or Twin Falls," then TV will have finally got it right. □



An Era of Falling Earnings and Rising Inequality?

*McKinley L. Blackburn, David E. Bloom,
and Richard B. Freeman*

For most of this century the average wage of U.S. workers has trended upward, with the wages of top earners and bottom earners growing more or less in step. But wage growth began to falter during the 1970s. Average real earnings departed from its long-run pattern of growth starting in 1973. During the 1980s the wage picture grew more bleak. Not only did average earnings fail to grow, the earnings of different groups of Americans began to diverge sharply. For some — mostly young, less educated and blue collar men — the 1980s job market was a disaster. For others — especially women with college degrees and educated and white collar men — earnings improved noticeably. Earnings gaps between a number of major demographic groups shifted conspicuously, and overall earnings inequality in the United States increased.

When national statistics first began to indicate that inequality was increasing in the early 1980s, economists were slow to believe that the United States had entered an era of rising inequality. Many economists assumed that the data simply reflected the massive 1981–83 recession, the worst since the Great Depression. Others ar-

gued that the data could be misleading — because of technicalities related to the choice of income deflator or the particular measures of income being used. But the sluggish movement of real earnings and the persistence of increased earnings inequality through the 1983–88 recovery effectively ended the debate over the pattern of change in earnings. By 1990 most economists who had examined the issue agreed on the basic facts that made the 1980s such a distinct and disturbing period in American economic history.

What are these facts? How far have we come in explaining the remarkable changes in the structure of earnings during the 1980s? What are the implications of the changes for American society?

Figure 1 shows percentage changes in real earnings for all workers and for workers in different demographic groups from 1979 to 1988. Four changes deserve particular attention.

First, real earnings declined more for young workers than for workers generally. Among workers aged 25–64 real earnings fell only a little — so little that trends calculated over different years or with other earnings series could show no change or even a slight increase. But for workers aged 25–34, real earnings fell sharply — an average of 1 percent a year. The trend, which began for some groups of young workers in the early 1970s, represents the longest sustained deterioration in real earnings since the end of World War II. Because younger workers are relatively unprotected by seniority or specific skills within companies, they are more likely

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than older workers to be affected by current job market conditions. As a consequence, their relative earnings are a better indicator of changes in the labor market than those of older workers.

Second, the fall in real earnings was limited to men. The pay of women actually rose. Of all the major wage gaps — by race, by educational level, by age, by gender — only the male-female earnings gap narrowed. That development makes it hard to argue, as many have done, that changes in the wage structure are based solely on changes in the value of skill in the market. The decline in the gender gap during the 1980s is also notable because the gap changed so little during the 1960s and 1970s. That it narrowed during the Reagan administration, which viewed affirmative action negatively and was at odds in many ways with the women's movement, shows that the gains for women did not depend on a politically favorable environment.

Third, average earnings among blacks changed at roughly the same rate as they did for all workers, implying rough constancy in the black-white earnings differential over the 1980s. That constancy itself marks a break in the steady narrowing of this differential since passage of the Civil Rights Act of 1964 and suggests that new strategies will likely be needed to restore the upward trajectory of relative earnings for black workers.

Fourth, the earnings of the less educated — high school dropouts and graduates — took the biggest tumble, with the greatest declines among younger workers. The college-high school earnings gap had been narrowing, at least among men, since the early 1970s as a result of the rapid expansion of higher education in the 1960s. But since 1980 that gap has widened significantly. The earnings gap also increased between more skilled groups, such as professionals and managers, and less skilled groups, such as factory workers. Overall, increased earnings differentials between skill groups (both education and occupation groups) represent a break in the long-run trend toward reduced skill differentials that had prevailed in the U.S. economy for most of the century.

The earnings gap between workers in different educational (and occupational) groups widened alike for all the principal demographic groups. As table 1 shows, the college-high school earnings gap increased during the 1980s for blacks and whites, for males and females, and for older and younger workers. At least some of the forces that are causing education-based differentials to widen are common to workers in all different demographic groups.

Earnings-Employment Trade-offs

Although most research on the economic position of American workers in the 1980s has focused on earnings, wages are not the sole measure of workers' economic well-being. In a world with involuntary unemployment,

rates of employment and unemployment also matter greatly. A decline in earnings accompanied by increasing employment may not necessarily signal a deterioration in workers' overall welfare. Indeed, if the chances of holding a job go up for groups that suffer large declines in real earnings, the overall economic well-being of those groups may actually increase.

For the United States as a whole, the fall in real earnings was indeed offset, at least in part, by growth of employment. During the 1980s an increasing proportion of the working-age population found jobs: the employment-population ratio for workers aged 25–64 grew from 59 percent in 1980 to 63 percent in 1989. That pattern contrasts sharply with that of most of Western Europe, where real wages increased but employment rates stagnated, and where unemployment overtook and then outstripped that in the United States. For whatever reason, the United States and Europe responded differently to the sluggish economic growth, the increased labor market activity of women, and the dramatic changes in technology and trade that took place during the 1980s. The United States reduced, or stabilized, real wages but increased employment, whereas Europe raised real wages at the cost of jobs.

As with the pattern in earnings alone, however, the picture for particular demographic groups is often strikingly different from the aggregate picture. Groups suffering losses of real wages also had falling employment-population ratios, while groups with increased real wages had growing employment-population ratios. Women, for example, enjoyed not only better wages, but increased employment, relative to men. And men with the largest decline in real wages, young white high school dropouts, saw no compensating rise in their employment-population ratio. The implication is that the changing structure of earnings among groups generally *understates* rather than *overstates* the worsening labor market position of those groups whose relative earnings fell in the 1980s.

The necessity of considering both employment and earnings in evaluating how different groups are faring in the labor market is particularly clear in the case of young black male dropouts relative to young white male dropouts. In terms of real earnings, black male dropouts did well compared with white male dropouts: their earnings, already low in 1979, increased slightly through 1988 while those of their white counterparts plummeted. But the 1980s was not an era of great economic advancement for black high school dropouts compared with white. Far from it. Despite the increase in the employment-population ratio for the United States as a whole, the proportion of young black dropouts with jobs fell sharply, from 68 percent to 56 percent, while the proportion of young white dropouts with jobs held fairly steady at around 80 percent. (The employment-population ratio had declined for both black dropouts and white dropouts in the 1970s.) In

fact, it appears that real earnings per individual (the jobless as well as the employed) fell substantially for both black and white dropouts in both the 1970s and the 1980s.

Causes

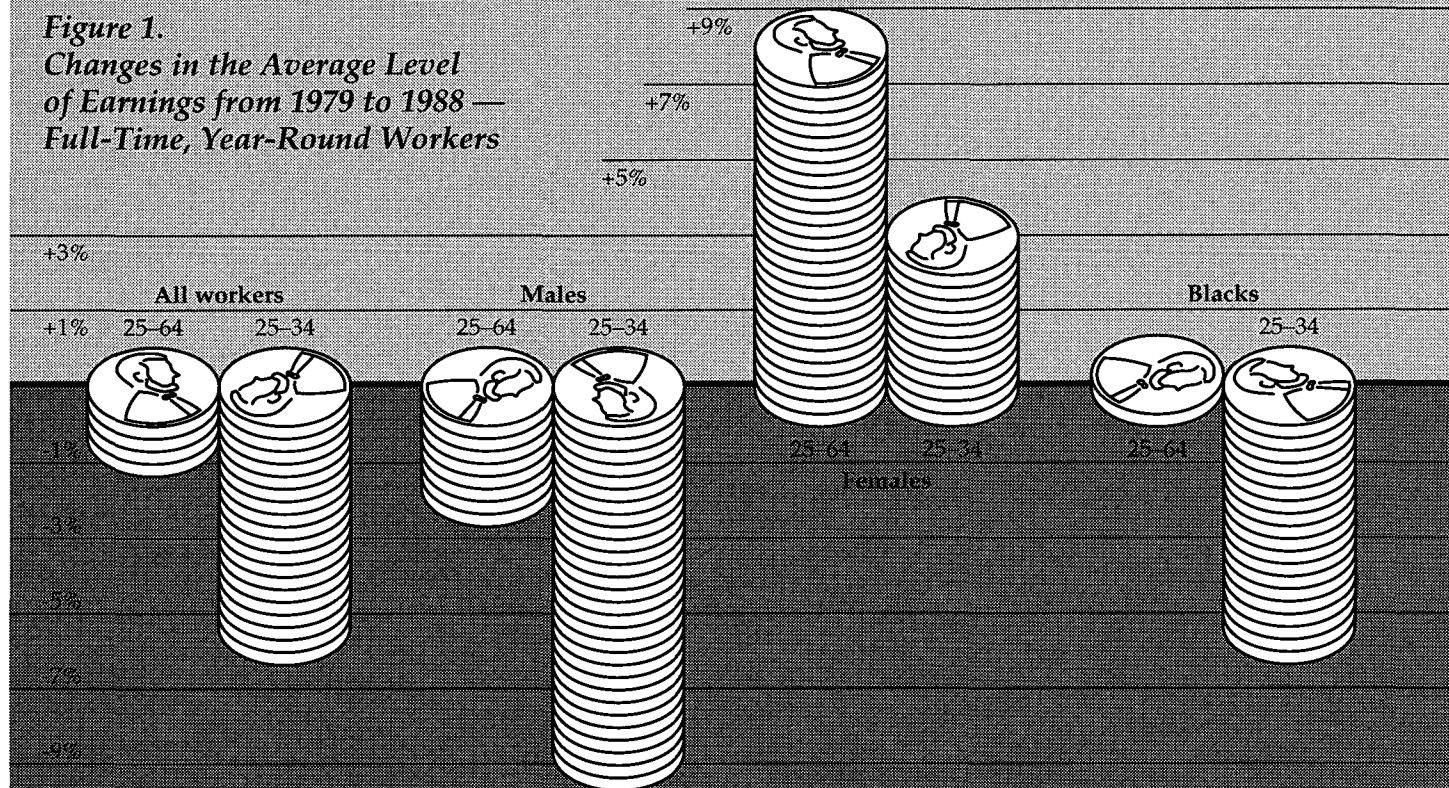
The \$64,000 question for labor economists is "What explains all these changes?" Despite considerable work by numerous researchers, no completely satisfactory explanation has emerged. A variety of demand, supply, and institutional developments appear to have been at work. Yet even these developments explain only a portion of the change in particular differentials or changes in only some of the differentials shown in figure 1.

On the supply side, changes in relative numbers of different types of workers help account for some of the changes in the wage structure. The idea here is simple: an increase in the size of one group of workers relative to some other group will tend to depress the relative earnings of the more rapidly expanding group — other things held constant. Thus, a decline in the relative proportion of young men with college degrees would be ex-

pected to increase the college–high school differential among men.

Among white men aged 25–34 working full time year-round, there were 9 college graduates for every 10 high school graduates in 1979. By 1988 the ratio had fallen to 7.3 college graduates per 10 high school graduates. The resulting relative shortfall of college graduates helped raise their earnings relative to those of their less educated counterparts. The fall in the relative number of college graduates is larger among white men aged 25–34 than in any other major demographic group, a fact that helps explain why the college-high school earnings gap tended to rise the most for that group (table 1). In addition, the rapid decline in the number of black high school dropouts relative to white dropouts (the result of increased black high school graduation rates in the 1970s) helps explain the better wage performance for black than for white dropouts. On the other hand, that decline cannot explain their worsened employment record. Furthermore, among women aged 25–34, the number of college graduates per 10 high school graduates *increased* from 6.2 to 7.6 between 1979 and 1988. These supply changes do not explain the rising earnings

Figure 1.
*Changes in the Average Level
of Earnings from 1979 to 1988 —
Full-Time, Year-Round Workers*



Source: The data come from the March 1980 and 1989 Current Population Surveys, which contain household-level information on income for the previous calendar year. The reported statistics represent percent changes in the geometric mean for inflation-adjusted wage and salary income only. Earnings are of full-time year-round workers and are adjusted so that they are expressed in constant dollars. Inflation adjustments were made using the GNP deflator for personal consumption expenditures.

gaps between women in different educational groups. Changes in the relative numbers of workers with various characteristics undoubtedly mattered in the different labor markets, but they do not provide a complete explanation for all the large shifts in the structure of earnings.

On the demand side, changes in the structure of industries — notably the decline of manufacturing and other sectors that traditionally hire less educated men — helped widen educational-earnings gaps. In addition, the tendency for virtually all industries to raise the educational qualifications of workers (despite the increased relative cost of the more educated) — perhaps because of technological changes — also tilted the job market toward the more skilled. But available evidence suggests that these developments explain only a portion of the shift in the educational differential.

In terms of institutions, the declining strength of unions has also lowered the real earnings of the less skilled. Among men aged 25–64, 47 percent of high school graduates and 40 percent of high school dropouts belonged to unions in 1980. By 1988 the unionization rate for high school graduates had dropped to 31 per-

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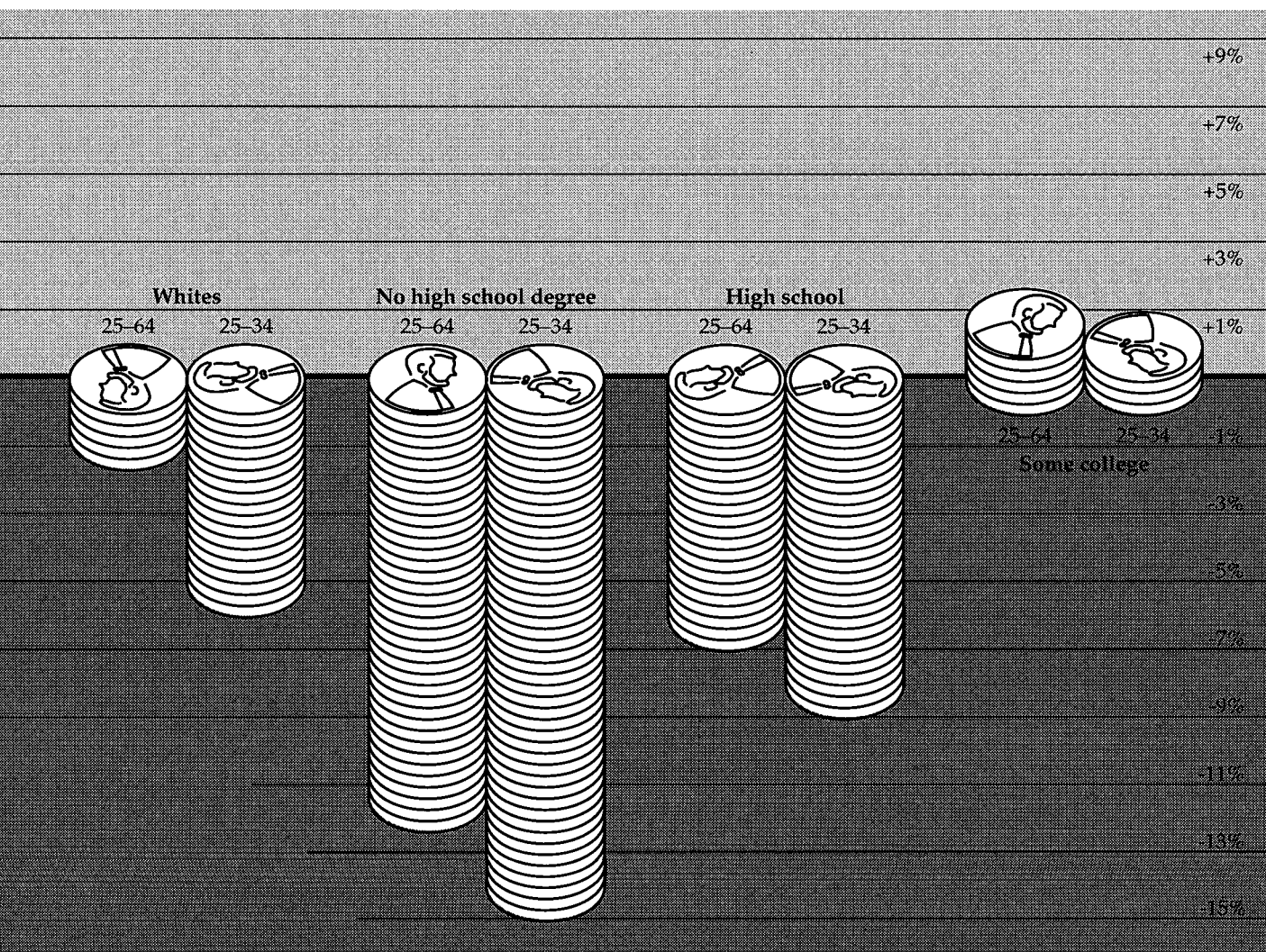
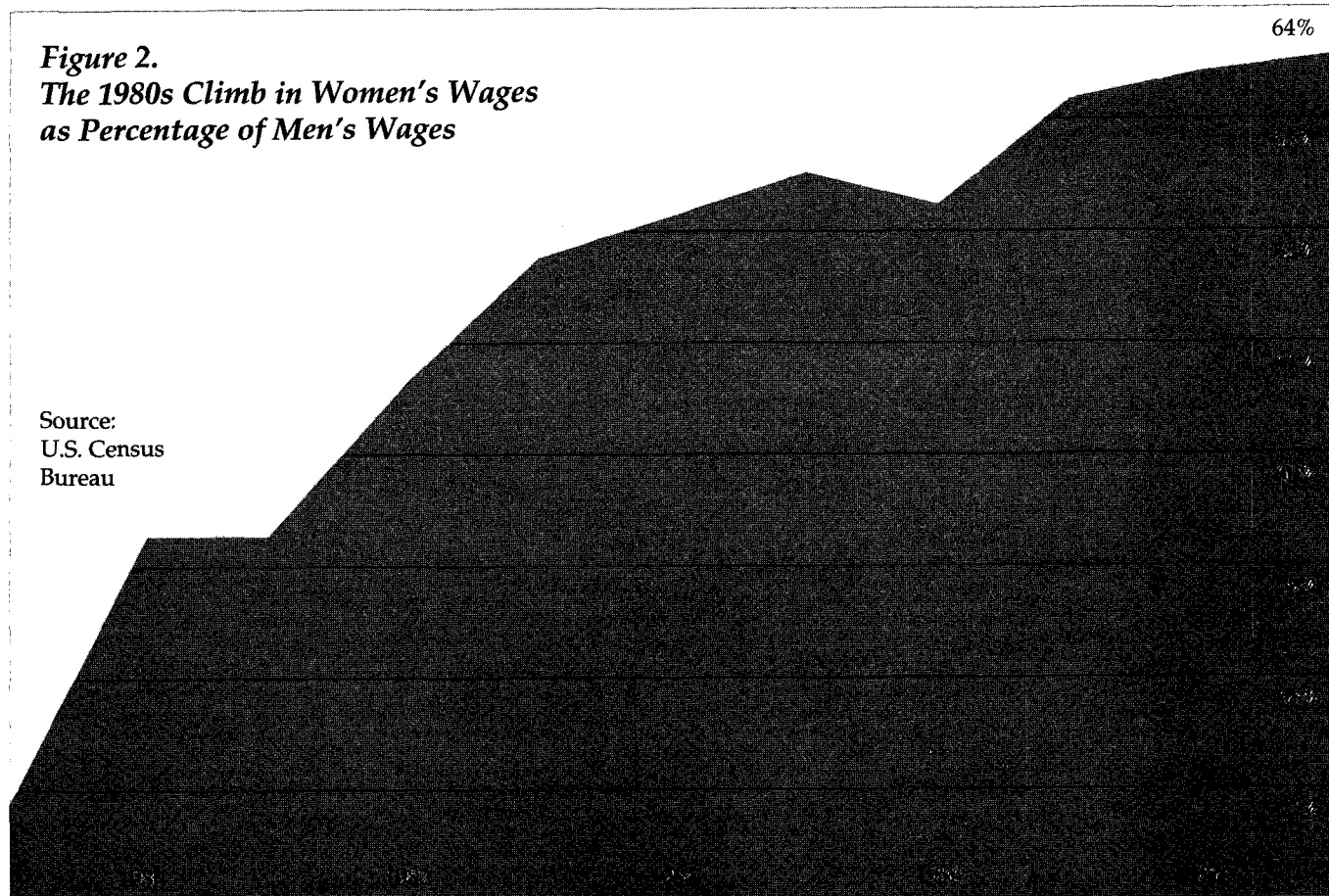


Figure 2.
The 1980s Climb in Women's Wages
as Percentage of Men's Wages

Source:
U.S. Census
Bureau



cent, while that for high school dropouts had declined to 25 percent. These drops in unionization meant lower pay for a sizable proportion of less skilled men. But the waning influence of unions is not the dominant cause of the decline in real earnings of the less educated or of the overall rise in earnings inequality.

Recent research makes it possible to reject some popular explanations of changes in the job market. As noted, the failure of earnings differentials to return to their pre-recession levels in the 1983–88 recovery rules out a pure business cycle explanation. The widening of wage gaps for older as well as younger workers (although to a lesser degree for the older cohorts) suggests that any recent deterioration in the quality of elementary and high school education does not fully account for the observed developments. The school quality argument also fails to explain the narrowing gender gap in earnings (see figure 2), since men and women typically go to the same schools. The fall in the real value of the minimum wage has only a slight effect on workers over age 25. And it has thus far proven difficult to base an explanation of the changing job market on advances in technology. Computerization and automation, in fact, have no clear effect on the nature of jobs. In some settings they increase demand for skilled workers, but in other settings they increase demand for unskilled workers. U.S. productivity during the 1980s showed only sluggish growth, not the rapid advance one might ex-

pect if technological change were the chief cause of the changing structure of wages.

In sum, numerous developments — in supply, demand, and wage-setting institutions — help account for increasing wage inequality. Even so, there is no “full accounting.” There are too many dimensions of change and too few data points to pin down causality as well as one would like. The uncertainty calls to mind efforts during the 1960s and 1970s to account for U.S. economic growth. Despite economists’ best efforts, a sizable “growth residual” stubbornly refused to be attributed to increases in employment, education, or capital.

The Experience of Other Countries

Is the United States the only developed country in which earnings have become more unequal? Can the experience of other industrialized countries help explain what is happening in the United States?

Detailed work on changes in the wage structures of other countries has just begun. Still, it is possible at this point to give at least a partial answer to the first question. Increases in the relative earnings of women are fairly common outside the United States, but huge increases in wage differentials based on skill are not. In fact, of the five countries whose wage structure we and other researchers have seriously examined, only the United Kingdom has experienced anything resembling

the growth of education-earnings differentials seen among men in the United States. America's closest industrial neighbor, Canada, has seen at most a slight rise in the college premium for men (though the premium has increased among women). Japan, Australia, Sweden, and France have also had virtually no increase in the wage premium paid for education or skill. The United Kingdom and Canada did, however, see a sizable increase in overall male earnings inequality during the 1980s.

There are two natural reasons for the apparent international differences. First, international supply and demand forces differ. In Canada, for example, a trade surplus and a large increase in the relative supply of college graduates helped keep skill gaps from increasing. In Japan, exports and the continuing strength of manufacturing may have had a similar effect. Second, wage-setting institutions clearly exert different influences on the wage structure. In particular, centralized bargaining in Sweden, union strength in Australia, and government involvement in wage setting in France appear to have prevented increases in wage gaps in those countries.

Implications

Do the developments of the 1980s mean that the United States is becoming a polarized society, with highly educated and highly paid workers moving further and further apart from less educated and lower paid workers? The increased inequality in the earnings of skilled and unskilled workers certainly represents a step in that direction. But the growing equality in the earnings of men and women complicates the picture. A society in which education and skill matter more in the job market than gender arguably has more to recommend itself than one in which gender counts for much and education and skill count for less. Still, the gap in earnings between the more and less educated has grown among women as among men. And inequality of earnings in the economy as a whole — our summary measure of the net effect of the various changes in the structure of earnings across and within groups — reveals an overall movement toward the extremes. That the rise in inequality has taken the form of declines in real earnings for many Americans, as opposed to increases for all workers with relatively more favorable increases for the higher paid, should be an issue of national concern.

Will education-earnings differentials continue to widen in the 1990s? We think not. The proportion of young people entering college is now on the rise. If young people respond to the higher earnings opportunities for investments in college and other skills, as they have in the past and appear to be doing today, earnings differentials between educational groups are likely to fall. Much of the rise in the college-high school gap took place in the early and middle 1980s; since then the gap has been roughly stable.

Table 1. Increase in Wage Premium for College Education, 1979–88

Percent except as noted

Group	Wage premium		Increase (percentage points)
	1979	1988	
<i>25- to 64-year olds</i>			
White males	25%	38%	12
White females	35	45	10
Black males	34	47	13
Black females	42	49	7
<i>25- to 34-year olds</i>			
White males	16	30	14
White females	32	44	12
Black males	32	39	7
Black females	28	39	11

Note: Data in the table are based on the logarithm of the ratio of the geometric mean of wage and salary income for college graduates to the geometric mean for high school graduates. These logarithmic differentials can be interpreted as representing percentage differences in earnings between workers in the two education groups.

Should government intervene in the wage-setting process to help the lower paid? Again, we think not. In a dynamic competitive economy, the earnings of some groups rise, and those of other groups fall, in response to shifts in supply and demand. These changes are signals to employers and workers to reallocate labor and investments in skills across the economy. They are the sign not of economic failure, but of the flexibility of markets. While we cannot explain fully the rise in skill differentials, there is no evidence — and indeed no serious argument — that they are the economically inefficient result of some market failure that requires government intervention to correct. The appropriate way to deal with the rise in earnings inequality is through taxation and transfer policies — to maintain adequate incomes for the working poor — and through public expenditures on education and training that encourage individual responses to the increased importance of education.

Is the situation a serious one? We think that it is. While our prognosis is more optimistic than some, we could be wrong. A bad recession in the 1990s could further exacerbate the economic position of less educated and lower paid Americans and threaten the country with even greater inequality. This possibility provides a good reason for policymakers and citizens alike to pay close attention to changes in U.S. earnings distributions as the 1990s proceed. □

Opportunity Missed: Mexico and Maquiladoras

Joseph Grunwald

In 1964 the United States discontinued its “bracero” program, whereby Mexicans were permitted to work on U.S. farms on a seasonal basis. With thousands of workers idled, the Mexican government faced massive joblessness along its borders. The solution it chose, after observing U.S. production-sharing arrangements in several East Asian countries, was to encourage U.S. industrialists to locate labor-intensive assembly operations just inside its borders to take advantage of Mexico’s comparatively low wages and proximity to the United States.

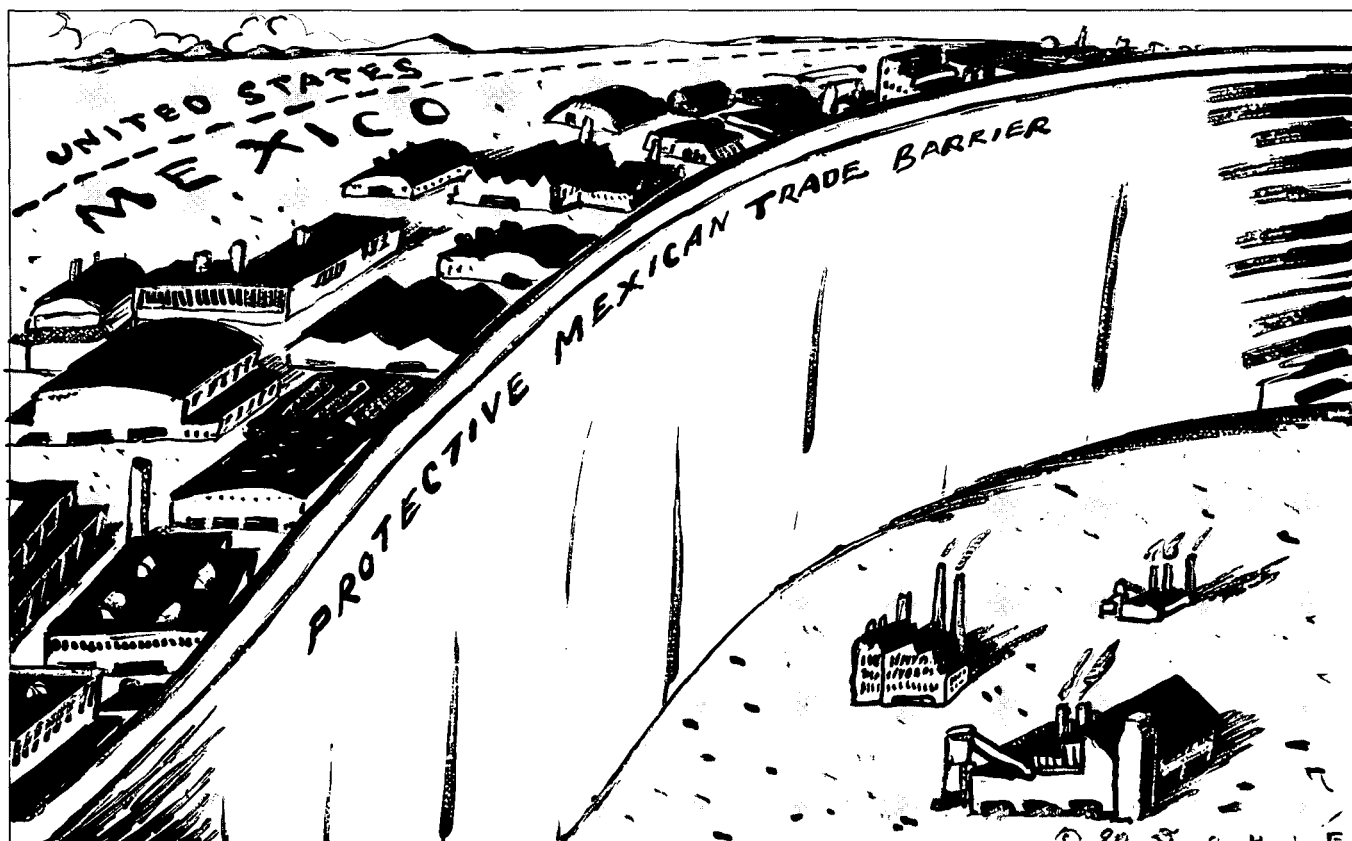
From a handful of assembly plants in the mid-1960s, the program has grown to more than 1,900 maquiladoras, as the plants are called in Mexico. Growth accelerated during the 1980s. From the early 1980s, when the debt crisis triggered Mexico’s current economic recession, to the end of the decade, the peso dropped from about 4 U.S. cents to less than 0.04 cents, and Mexican wages in dollar terms fell from the highest in the third world to among the lowest. Today maquiladoras provide jobs for half a million Mexican workers, about one-

tenth of the industrial work force. Perhaps more important, the maquiladora, after petroleum, has become Mexico’s largest foreign exchange earner, providing almost 15 percent of export earnings.

The maquiladora industry is now Mexico’s most dynamic sector — testimony, one would think, to the wisdom of the Mexican government’s policy choice. In fact, the maquiladoras represent an opportunity passed by. Despite the jobs created and foreign exchange generated, maquiladoras have remained on the fringes of the Mexican economy and have contributed little or nothing to advancing industrialization, technological growth, or international competitiveness.

In the meanwhile, assembly plants in Hong Kong, Singapore, South Korea, and Taiwan — the very plants on which the Mexican maquiladoras are modeled — have not only led the East Asian countries’ drive to create a manufacturing industry. They have become a springboard for industrialization, a spur to international competitiveness, and an engine for economic growth. By making shrewd use of the assembly plants, the “four tigers” moved up the ladder of technology and upgraded their labor force, allowing initially abysmally low wages to increase as technology rose through education, training, and improved job skills. Having integrated the production technologies and managerial skills in the assembly plants into their own domestic economy, the four tigers have moved beyond domestic production to engage in rapidly growing export production — even to the point of beginning to locate their own assembly plants in Mexico.

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How Did It Happen?

Why have the Mexican assembly plants lagged so badly behind their East Asian counterparts in contributing to development? The answers are rooted in Mexican government policy, bolstered by Mexican public opinion and by the interests of the U.S. companies that operate most assembly plants in Mexico.

From the beginning the Mexican government intentionally isolated the maquiladoras from the rest of the Mexican economy. As established, the maquiladora program was strictly a border job-creating program. The Mexican government permitted duty-free imports of U.S. machinery, equipment, and components for processing or assembly within a 20-kilometer strip along the border, provided that the output was exported. The United States, for its part, loosened U.S. tax codes to permit duty-free reimports of U.S. components assembled abroad, so that only value added abroad is dutiable. Although subsequent Mexican legislation permitted maquiladoras to be built in the interior of Mexico, more than 90 percent of the plants still cluster in Mexican towns near the U.S. border. And although 1983 and 1989 decrees permitted the sale of up to 20 percent and 50 percent, respectively, of maquiladora output in Mexico, local businesses' fears of "unfair" competition have resulted in only a negligible amount of licensed domestic sales so far.

The result has been that assembly production has remained physically separate from other industrial pro-

duction, so that Mexican managers and technicians in the maquiladoras have had little opportunity to apply to other economic activities what they learn from technologically advanced foreign plants. During the early days of the maquiladora, most assembly operations involved apparel and other textile production, as well as other "light" and technologically unsophisticated output, such as gloves, toys, and dolls. The situation soon changed, as important U.S. electronic firms and automobile and machinery producers shifted their assembly operations to Mexico. The bulk of maquiladora production now consists of automotive assembly (vehicles and parts), machinery and equipment, television, and other electronic assembly, such as semiconductors and office machines. Today high-tech production makes up more than three-quarters of maquiladora output — and represents a good source for technology transfer.

Mexican firms and industries have also been deprived of direct access to sophisticated subassemblies produced by the maquiladoras, sometimes forcing them into the absurd situation of having to import from the United States, for their own production, high-tech Mexican-made items. Restrictive Mexican trade policy has also made it difficult, if not impossible, for domestic Mexican industry to help supply the maquiladoras. Protected by high trade barriers until recently, Mexican firms have not been internationally competitive. They have been unable to meet international prices, quality standards, and delivery schedules. As a result, of \$10 billion in components used in assembly plants in 1989,

less than 2 percent was of Mexican origin, and the proportion has been trivial since the beginning of the maquiladora program.

The situation was quite different in East Asia, where assembly plants quickly emerged from export processing zones to become a part of the national economies. No restriction limited selling output within the country. From the beginning, local firms in the four tigers were involved in assembly industries as subcontractors, in joint ventures, or as suppliers doing assembly work and production for the home market and for export under the same roof. Entrepreneurs, managers, and workers learned technologies and know-how from U.S. parent companies and applied them to production. Soon, local firms supplied most components previously imported from the United States. It did not take long for four tiger firms to make these products from beginning to end. Nor did it take long for them to begin to export their wares.

Second-Class Citizen

But Mexican government policy is not alone in isolating the maquiladoras. From the beginning Mexican public opinion has relegated assembly work to a distinctly second-class economic status and has deemed it

The aim of the Mexican government in restricting the maquiladoras to the border was to help ease the joblessness there. U.S. businesses are happy to have the plants on the border because that minimizes transportation costs. It also permits factory managers to live in the United States and work across the border in Mexican plants

unworthy of significant Mexican resources and effort. It is an attitude born in history. By the time its first assembly plant was built, Mexico, quite unlike the East Asian four tigers, was already a semi-industrialized country. About one-fifth of its labor force was in manufacturing, which produced about one-quarter of Mexico's gross national product. Substantial "heavy" industry was in operation. Not surprisingly, getting national capital and energy involved in manual assembly was viewed as industrial retrogression. That perspective has been reflected in public policy. Even in official Mexican foreign trade statistics, sales of the maquiladoras to the United States and other countries are recorded as services rendered to foreigners and not as exports of manufactured goods.

Mexican academics and others have also accused the maquiladoras of sweatshop exploitation, pollution, and health hazards. Observers have complained that Mexican workers in the border plants spend their wages across the frontier in the United States, thus wasting valuable foreign exchange earnings. Critics also point out that employment in the maquiladoras has gone largely to young, low-wage, and nonmilitant women who were not previously in the work force, not to men, who form the bulk of the under- and unemployed. Ironically, some of the same people who disdain assembly work and wish to keep Mexican resources away from it also complain that it does not contribute to Mexican industrialization. But a controlled foreign enclave cannot reasonably be condemned for not being integrated into the national economy and not doing more for national economic development.

Where Does U.S. Business Come In?

Working together with Mexican government policy and Mexican public opinion to keep the maquiladoras on the sidelines of Mexican industry are U.S. business interests, who now save about three-quarters of assembly wage costs by operating assembly plants in Mexico. The aim of the Mexican government in restricting the maquiladoras to the border was to help ease the joblessness there. U.S. businesses are happy to have the plants on the border because that minimizes transportation costs. It also facilitates trouble-shooting by managers and engineers based at U.S. headquarters and permits factory managers to live in the United States and work across the border in Mexican plants. Although increased transportation costs to plants located in the interior might be offset by lower wage costs, U.S. firms would miss amenities of the faraway U.S. border and might also find the backcountry housing, roads, and utilities, especially communications, wanting.

On the other hand, the border infrastructure has become increasingly strained because of overcrowding resulting from the recent maquiladora explosion. Many areas along the border have experienced shortages of water, sewage facilities, schools, housing, hospitals,

Education Must Become a Priority

The four tigers, as Japan before them, have clearly perceived that healthy economic development through international competition demands increasing technology, and that technology is transferred through human beings, not sophisticated machines. Only a well-trained work force can absorb new technology, adapt it to local conditions, and improve upon it through innovation. Because technology is ever rising, the work force must be continually upgraded. In East Asia, education has been a top priority.

Although Mexican educational levels are among the highest in Latin America, and Latin American educational levels are near the top in the third world, education has not enjoyed as high a priority in Mexico as it has in East Asia. For

example, in 1965 the proportion of 12- to 17-year olds enrolled in secondary education in South Korea was more than double that in Mexico, and the gap had not improved much by the mid-1980s. The lag is even worse for higher education. According to World Bank data, the percentage of 20- to 24-year olds in higher education was two and a quarter times higher in South Korea than in Mexico in 1987.

Calculations based on data from the National Science Foundation indicate that, allowing for differences in population size, more than 10 times more Koreans than Mexicans — and 40 times more Taiwanese than Mexicans — received Ph.D. degrees in the United States in engineering and the physical sciences between 1960 and 1988. Even in the

social sciences the far-away East Asians exceeded the next-door Mexicans by 10 times.

Obviously this last set of data must not be interpreted as reflecting the true discrepancies in education levels between Mexico and East Asian countries. For one thing, it has been generally recognized that, on average, Mexican universities have been superior to those in the East Asian countries. Mexican students may simply not have felt the need to study abroad. For another, a greater proportion of Mexicans may have studied in universities in other countries than have East Asians. Nevertheless, the differences are so striking that they must reflect a significant difference in emphasis given to education in the two regions.

transportation, and other public services. A few also suffer from pollution caused by some maquiladoras, especially in furniture assembly. Some spots along the border have even experienced labor shortages. Such considerations have indeed led some firms to establish maquiladoras further inland — but almost always less than 200 miles from the U.S. border.

Even in plants located on the border, U.S. firms are hesitant to share ownership of plants and vital technology with Mexican firms, preferring to assemble in their own subsidiaries, where they can control production schedules and quality, as well as safeguard their technology.

Nor are U.S. businesses likely to give up component production to Mexican firms. Although U.S. enterprises seemed content to let East Asian firms begin to produce their own components during the 1960s, thus saving transportation costs, with the product imported into the United States more cheaply than U.S. components could be assembled abroad, the circumstances in Mexico are different. Mexican plants, especially those along the border, are too close to the United States to offer significant savings in transportation costs.

U.S. workers too are unlikely to want to see a larger share of maquiladora inputs produced in Mexico. American workers have long been told that the advantage of production sharing is that it permits U.S. firms to remain competitive and stay in business by transferring assembly work abroad but maintaining employment at home for production of machinery, equipment, and, es-

pecially, components for the maquiladoras. That argument would sound hollow indeed if components began to be produced in Mexico. The long-run benefit to the U.S. economy from a strengthened Mexican trading partner may not be persuasive to U.S. workers who must lose their jobs today.

Strong Medicine

The maquiladoras will not easily overcome all the forces confining them to their marginal role in the Mexican economy. The national prejudice against assembly production will not fade quickly. The government has taken some small steps to allow the maquiladora to take a real part in the nation's manufacturing sector. If it tries to take more significant steps, both local and U.S. business interests are likely to weigh in heavily on the side of the status quo. But if the maquiladora is to be integrated into the Mexican economy, if production sharing is to shed its role as a marginal provider of low-wage jobs and become the stimulant of growth it has been in East Asia, the government must take strong action.

First, the government must encourage Mexican capital and Mexican entrepreneurs to participate in assembly production as owners and suppliers. The government made a good beginning in the late 1980s by abandoning protective trade policies. The elimination of unreasonable protection of Mexican industry will force Mexican firms to become more cost- and quality-con-

scious, and thus more internationally competitive, providing the basis for them to venture into production for exports and for the maquiladora. Although Mexican import tariffs are now among the lowest in Latin America, remaining trade barriers on imported inputs hinder export production. Eliminating such barriers would help Mexican firms supply maquiladoras at internationally competitive prices.

Greater international competitiveness would also make Mexican producers desirable partners in joint ventures with foreign companies or attractive subcontractors for firms in the United States, Japan, or elsewhere. If Mexican firms as partners or subcontractors are also engaged in non-maquiladora activities, such as producing home-market goods, the transfer of technology to other productive activities can occur, as it has in East Asia, almost automatically.

The Mexican government should also encourage the emergence of national suppliers by applying *temporary* national content agreements to maquiladoras — even though that would mean contravening free market principles. In the case of U.S.-owned (non-maquiladora) automobile and computer plants, such temporary agreements to purchase a minimum proportion of inputs from local sources have created a significant Mexican supplier network. Now that Mexican production is becoming more competitive through the elimination of protection, short-lived national content agreements would be cost effective for foreign or domestic maquiladora firms.

Second, the government must relax its limits on the sale of maquiladora output in the domestic market. It did take, in mid-May of 1989, the dramatic step of rescinding the requirement of Mexican majority ownership and permitting up to 100 percent foreign ownership in all but the largest manufacturing enterprises. Because maquiladoras have all along been permitted to be 100 percent foreign owned, it is to be hoped that the 1989 decree will allow the conversion of a 100 percent foreign-owned maquiladora to a regular manufacturing enterprise. If so, assembly production can exist side-by-side with other production and, presumably, can be sold without restriction in the country. A logical extension would be that not only foreign majority-owned plants but also Mexican majority-owned maquiladoras would be permitted unlimited domestic sales of assembly output. The most recent — December 1989 — Mexican government decree, however, limits the sale of maquiladora output on the domestic market to 50 percent of the previous year's net export earnings for each firm.

Third, Mexican workers, supervisors, and managers must be better educated and trained in new technologies, know-how, and skills. Several major U.S. firms have already gone far in upgrading the skills of their Mexican employees. Some provide further training for Mexican technical and supervisory personnel in the parent companies in the United States. More needs to be

done by foreign firms. But education, the enrichment of Mexico's work force, is primarily a Mexican responsibility as an essential part of economic development.

And, finally, the government must provide strong incentives for maquiladoras to expand into the Mexican interior. Experience has shown that maquiladoras in the interior have greater linkages to the local economy than those at the border: a larger share of materials used in plants is of national origin and there is no leakage of wages into the United States. Moreover, assembly plants, while taking advantage of lower labor costs, can both reduce underemployment and raise incomes by locating in the large pockets of poverty in Mexico's interior.

To entice plants into the interior, the Mexican government should provide even stronger incentives than those used by state governments in the United States in the establishment of "enterprise zones." In addition to special tax exemptions, subsidies will be needed, such as the provision of factory buildings with appropriate infrastructure, training of the labor force to provide minimum skills for the maquiladora, and credits on favorable terms. The size of the subsidies should be related to the region involved and should depend on the employment generated and the degree of use of local material inputs. Such incentives should be available to Mexican as well as foreign maquiladora investors.

The Future

In a dramatic turnabout, President Salinas of Mexico announced in March of 1990 that he would seek a free trade agreement with the United States. After years of greeting with nationalist disdain any initiatives from U.S. sources regarding such an agreement, Mexican opinion and policymakers have come to realize that their economic options with Europe and Japan are limited. The U.S.-Canadian free trade agreement became the model. By mid-1990 the United States, after initial hesitation, called for speedy negotiations to reach a free trade agreement with Mexico.

The expansion of the maquiladora industry has combined with the debt crisis of the 1980s to tie the Mexican economy more closely to the United States. In effect, a silent economic integration has taken place between the two countries in recent years. More than two-thirds of Mexico's foreign trade is now with the United States, and Mexico has become, after Canada and Japan, the third leading U.S. trading partner. It is ironic indeed that the maquiladora that has contributed so much to the movement toward integration with the United States, and thus also Canada — leading to an expected trading block stretching from the Yukon to the Yucatán that would be the largest in the world — has yet to be integrated into the Mexican economy. But a U.S.-Mexican free trade agreement could, by eliminating the need to keep the maquiladora separate from other economic activities, be the answer. □

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